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TAX REFORM PROPOSALS—XVI

HEARING

BEFORE THE

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UNITED STATES SENATE

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Debate on International Competitiveness of U.S. Businesses

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TAX REFORM PROPOSAL—XVI

THURSDAY, JULY 18, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Danforth, Chafee, Symms, Grassley, Long, Baucus, and Bradley.

[The press release announcing the hearing follows:]

[Press Release, Tuesday, June 25, 1985]

TAX REFORM HEARINGS IN FINANCE COMMITTEE TO CONTINUE IN JULY

Examination of President Ronald Reagan's tax reform proposal will continue in July with a series of hearings before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon), said today.

"We made a good start on the hearing portion of this long process toward overhaul of the Internal Revenue Code during June," Senator Packwood said. "The hearings we have scheduled for July will take us further toward our goal of having a bill to the President by Christmas."

The hearing announced today by Senator Packwood include:

On Tuesday, July 18, witnesses, invited by the Committee will discuss the impact of the President's tax reform proposal on the international competitiveness of U.S. businesses.

The CHAIRMAN. The hearing will come to order, please. As those who have covered these hearings for the press are aware, from time to time we arrange a pro and con debate on some facet of the President's tax reform proposals. And today we have such a format. The proposition is: Does the President's tax reform proposal diminish the ability of U.S. businesses to compete in international markets? Arguing for the proposition, that is that it does diminish our ability to compete. is Edmund Pratt, the chairman and chief executive officer of Pfizer in New York, and Laurence Mauer, associate professor from St. John's University in New York. Arguing against it are Larry Langdon, the director of taxation and distribution for Hewlett-Packard in Palo Alto, CA, and John Makin, director of fiscal policy studies at the American Enterprise Institute for Public Policy Research in Washington, DC. And the speakers will speak in the following order: Mr. Pratt, Mr. Langdon, Dr. Mauer, and Dr. Makin. I believe that Senator Symms has an opening statement.

Senator SYMMS. Thank you very much, Mr. Chairman, and I want to welcome all of the witnesses this morning, and Mr. Chairman, I want to compliment you and the staff of the Finance Com-

mittee for the way you have been arranging these hearings. I think this is very beneficial for the members of the committee to hear both sides of this debate. With the quality of these witnesses, we will probably end up thoroughly confused when they are finished. I want to apologize to the witnesses. My staff will be here, and I will read over your remarks, but I also have the responsibility of being chairman of the Surface Transportation Committee, and we have hearings on highways. Unless I can enlist another Senator on that committee to chair those hearings for me, I am going to be required to be upstairs in the Public Works Committee. So, I am going to excuse myself, but I really do look forward to seeing your points of view. We have two large Hewiitt-Packard installations in Idaho, so I am certainly interested in that, and I am a good friend of Mr. Pratt's and his organization. And they have substantial interests in Idaho also. I have a very parochial interest in both sides of the argument, I world like to point out. I thank you again, Mr. Chairman, and I welcome all of you here. And I apologize for my absence.

The CHAIRMAN. Thank you, Senator. You have been very faithful in attending these hearings, and I hope you can get back. Senator Roth, any comments before we start?

Senator ROTH. No, not at the moment, Mr. Chairman.

The CHAIRMAN. Mr. Pratt, why don't you go ahead?

STATEMENT OF EDMUND T. PRATT, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PFIZER, INC., NEW YORK, NY

Mr. PRATT. Thank you, Mr. Chairman. My name is Edmund Pratt. I am chairman and chief executive officer of Pfizer, a research-based pharmaceutical company with worldwide sales of about $3.9 billion in 1984, of which 44 percent were from foreign operations. My statement is submitted on behalf of Pfizer as well as the 62 other companies which comprise the Emergency Committee for American Trade, known as ECAT, of which I am chairman. ECAT members have combined annual sales in excess of $700 billion, and they employ more than 5 million people. Let me say first that I recognize that the allure of a major tax reform is indeed powerful, but I am not yet convinced that the enactment of the president's overall package will achieve its stated goals without creating significant and, in my view, unacceptable costs to the American economy and our ability to compete in the world marketplace. The proposals are too numerous, and their interactions are too complex to be wisely undertaken all at once. We simply do not know their probable effects on sustained, long-term growth of the economy or on the various business sectors. In expressing his concern on this very point, one of your former colleagues in the House, Barber Conable, referred to himself as a "flaming incrementalist." I am one, too. My concerns are not attributable to the impact of any particular proposal on Pfizer. In fact, many companies including Pfizer may well be beneficiaries of the President's package, if one simply compares pre- and post-reform tax liabilities, particularly as the bill stands at any one moment. If, however, enactment of this package has far-reaching adverse effects on the American economy and on our ability to compete internationally, we are all

losers. To the extent jobs and in rates are rendered meaningless. In my view, a significant reduction in the Federal budget deficit must remain our legislators' number one priority, because tax reform is given serious consideration. The Federal budget deficit not only threatens the future growth and stability of our domestic economy, it is also a principal factor affecting the ability of U.S. industries to compete abroad through its impact on the current strength of the U.S. dollar. Let me now comment on the possible implications the president's tax proposal has for U.S. international competitiveness. While there are winners and losers under the plan, it will nonetheless result in an overall net increase in business taxes of almost $120 billion over 5 years, as I understand This is no small amount by any measure and translates into an extra cost of doing business for American firms not borne by our foreign competitors. The implications of this for the ability of American companies to compete in both domestic and foreign markets is inescapable. Consider the impact of certain provisions on the following barometers of international competitiveness. First, capital investment in the U.S. economy. Pfizer is not a capital intensive company; it is knowledge intensive. As such, other witnesses are in a better position to address the problems posed by the repeal of the investment tax credit and change in depreciation rules from more first-hand experience. Let me just say that, to the extent an increased cost of acquiring capital equipment in this country further impairs the ability of U.S. companies to expand and modernize plants and equipment, it will diminish the international competitiveness of U.S. companies and workers and further increase the vulnerability of U.S. companies and domestic employment to foreign imports. Due to technological innovation, a second factor affecting U.S. international competitiveness is technological innovation. This has been a major source of the U.S. comparative advantage in the past. Our Federal tax system does have an impact on the willingness of American firms to devote resources to research and development and the expansion of the U.S. technological base. It is only through such investments that the United States can hope to develop and produce the new and better products and services that will become the source of our competitive edge in the global future. Global competition in R&D is formdible. The United States has a large R&D effort in absolute terms. However, U.S. civilian R&D ranks lowest among the big five industrial nations relative to our GNP. Recognizing the importance of technological innovation, the Congress adopted the R&D tax credit in 1981, to spur industrial research programs. This credit will expire at the end of this yar. The reasons leading to its enactment in 1981 remain with us today. R&D credit should be made permanent and should be expanded to cover basic research by universities and private nonprofit research institutes. Section 861 regulations. As many of you are aware, the R&D allocation requirements of section 861.8 are currently subject to a moratorium that expires the end of this year. The impact of these rules is to effectively deny U.S. companies full tax benefits for purely domestic R&D expenses. We are the only country in the world to impose such an additional burden on our companies. It creates an incentive to move R&D out of the United States where it is treated more fairly. This is not in the U.S. interest, and section 861.8 should be

repealed. U.S. direct investment overseas—and I see, I am running out of time—is a direct measure of the ability of American firms to penetrate foreign markets that can't be effectively reached by U.S. exports. The benefits of such investments to the U.S. domestic economy are substantial. In 1980, our last data, almost $90 billion, or 40 percent of all U.S. manufactured exports, represented sales to U.S. subsidiaries abroad. Repatriated earnings in 180 amounted to more than $70 billion, increasing the pool of domestic capital for investmentss in the United States. This positive contribution seems to have been overlooked in the President's proposal to abandon the long-standing method of calculating foreign tax credits by the overall limitation and replacing it with a per-country limitation. Treasury seeks to justify this by suggesting that the per-country method is consistent with international practice and is necessary to deter excessive tax-motivated investment abroad.

The CHAIRMAN. I will have to ask you to conclude, Mr. Pratt.

Mr. PRATT. All right. We couldn't be more mistaken. Our record shows that other countries, indeed, do use the overall kind of limitation, and this kind of a loss would be absolutely critical to our competitiveness abroad; and therefore, I would say it is perhaps the most important factor in the bill that we are concerned about. Thank you, Mr. Chairman.

The CHAIRMAN. I might add, because you didn't get a chance to do so, right at the end of your statement, you have a reference to the business transfer similar to the bill introduced by Senator Roth.

Mr. PRATT. That is right, Senator.

The CHAIRMAN. I am not saying that Pfizer is endorsing it, but they think it is at least something we should consider.

Mr. PRATT. Yes, Mr. Chairman, it needs to be considered.

The CHAIRMAN. Mr. Langdon.

[The prepared written statement of Mr. Pratt follows:]

STATEMENT OF

EDMUND T. PRATT, JR.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF

PFIZER, INC.

BEFORE

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 18, 1985

Introduction

My name is Edmund T. Pratt, Jr. I am Chairman and Chief Executive Officer of Pfizer, Inc. Pfizer is a research-based pharmaceutical company, with additional businesses in specialty chemicals, agriculture, materials sciences, and consumer products. In 1984, Pfizer had worldwide sales of $3.9 billion, of which 44% were from foreign operations.

My statement is submitted on behalf of myself and Pfizer. My comments on the taxation of foreign investment are made on behalf of the 63 members of the Emergency Committee for American Trace (ECAT), of which I am chairman. ECAT was formed in 1967 to support measures which expand international trade and investment. Its members are major exporters and investors in foreign markets. The 63 members of ECAT have combined annual worldwide sales in excess of $700 billion, and they employ more than 5 million people.

This statement will discuss the potential impact of the President's tax reform package on the ability of American business to compete overseas. I will focus on its projected effects on the three traditional barometers of

international competitiveness -- capital investment in the U.S. economy, technological innovation, and productivity. I will also discuss a fourth factor which is of substantial importance to members of ECAT -- U.S. foreign direct investment. The contribution of these factors to the competitiveness of U.S. firms was recognized, indeed was emphasized, by the President's Commission on Industrial Competitiveness.

I. Major Tax Reform

A. General Concerns

The allure of a major tax reform package is indeed powerful. At one time or another, I suspect that most individual taxpayers and business executives have succumbed to the appeal of rearranging the federal income tax, particularly when that effort is intended to result in lower tax rates across the board.

But I am not yet convinced that enactment of the President's overall package will achieve these results without creating significant and, in my view, unacceptable costs to the American economy. The proposals are too numerous and their interactions are too complex to be undertaken all at once. If we are to have any confidence that we understand their probable effects on sustained long-term growth of the economy as a whole, as well as their effects on various business sectors, I believe that a slower-paced timetable than envisioned by the Administration is essential.

Amidst the current enthusiasm for tax reform, it is too easily forgotten that our income tax laws, albeit complex, did not arise -- nor do they operate -- in a vacuum. Specific provisions were crafted over several decades to have an influence on economic behavior. While some are based on traditional tax

principles, others are designed to promote legitimate public policy objectives such as capital investment, technological innovation or the provision of broad-based health, retirement and educational benefits for our work force. As one of your former colleagues in the House, Barber Conable, commented "the things we call loopholes are, in fact, legislated responses to demands for fairness and other social benefits."

I agree with Mr. Conable that tax-based inducements for legitimate and ongoing public policy goals cannot be dismantled overnight -- even when accompanied by substantial tax rate reductions -- without potentially serious economic repercussions and social costs. It is for this reason that I believe tax reform, and hopefully tax simplification, must be an evolutionary process, rather than the dramatic restructuring which the President has proposed.

My concerns are not attributable to the impact of any particular proposal on Pfizer. In fact, many companies, including Pfizer, may well be beneficiaries of the President's package, if one simply compares pre-and-post reform tax liabilities. The substantial benefit of numerous positive features of the President's package -- notably the 33% corporate rate and the 10% dividend deductibililty -- would produce lower tax liabilities than present law for many taxpayers. If, however, enactment of this package has far-reaching adverse effects on the American economy and on our ability to compete internationally, we are all losers, no matter how our tax computations are affected. To the extent jobs and profits in the economy as a whole are lost, any reductions in rates are rendered meaningless.

B. The Deficit and the Dollar

In my view, a significant reduction in the federal budget deficit must remain our legislators' number one priority, before tax reform is given serious consideration. The federal budget deficit not only threatens the future growth and stability of our domestic economy, it is also a principal factor affecting the ability of U.S. industries to compete abroad. The current strength of the U.S. dollar which is hurting companies in all U.S. industries, including Pfizer, can be directly linked, in my view, to high real interest rates in the U.S. at least partly caused by unprecedented levels of federal borrowing to finance the deficit.

I applaud the progress Congress has made in this regard to date, and I urge that the difficulties faced by the Conference Committee on the budget not be allowed to destroy that progress. Further action is necessary, however, to put the deficit on a clear downward course for the future.

II. Impact Of The President's Package On International Competitiveness

Today, we live in and do business in a truly global economy. Our economic well-being and that of our trading partners are intricately intertwined. While the U.S. remains the largest market in the world, domestic jobs and revenues are influenced by the abililty of American businesses to compete in foreign markets and to meet the increased competition from imports in domestic markets.

It is for this reason that the President's tax package -- indeed any major tax reform package -- must be carefully evaluated to determine its effects on the competitiveness of America's international business. As I noted earlier, the four factors by which tax reform should be measured are U.S. direct investments

overseas, capital investment in the U.S. economy, technological innovation, and productivity. Productivity, the manner in which our labor force can be made more efficient through the use of new plant and equipment or the introduction of new technology or new products, will be discussed under those headings.

A. U.S. Direct Investment Overseas

U.S. foreign direct investment is a direct measure of the ability of American firms to penetrate foreign markets that cannot be effectively reached solely by U.S. exports. Such investments are driven by the need to overcome trade barriers, gain access to raw materials, meet foreign regulatory requirements, reduce transportation costs and provide distribution and servicing facilities for foreign markets.

The benefits of such investment to the U.S. domestic economy are substantial. It generates significant export income and export related jobs in the U.S. In 1980, $87.7 billion, or 40+ of all U.S. manufactured exports, represented U.S. sales to U.S. subsidiaries abroad. Remittances to the U.S. from foreign subsidiaries (excluding royalties) in 1980 amounted to $72.7 billion. This represented 30+ of the $247 billion in income subject to U.S. tax reported by U.S. corporations that year. Such remittances increase the pool of domestic capital for investments in the United States.

In stating U.S. Government Policy on International Investment in 1983, President Reagan himself stated:

> "...international direct private investment plays a vital and expanding role in the U.S. and world economies. It can act as a catalyst for growth, introduce new technology and management skills, expand employment and improve productivity. Foreign direct investment can be an important source of capital and can stimulate international trade."

Williamsburg Declaration on Economic Recovery, May 30, 1980, Appendix O.

Regrettably, the positive contribution of U.S. overseas investment is often overlooked and frequently misunderstood. In fact, a major shortcoming of the President's tax package relates to the taxation of foreign source income. In addition to recommending substantial changes in sourcing rules relating to U.S. exports, it would abandon the longstanding method employed by the U.S. to calculate the foreign tax credit.

Under the current law, U.S. firms with foreign source income from such direct investment are permitted a credit against U.S. tax liability on such income for foreign income taxes already paid. This foreign tax credit is limited, however, in that it may not be used to offset U.S. taxes on domestic source income. Moreover, it may not exceed the amount of tax the U.S. would impose on the same foreign source income. For the purpose of calculating the amount of foreign tax credit allowable, current law requires U.S. companies to use the "overall limitation" method whereby all foreign source income and all foreign taxes paid are aggregated into a single separate basket.

Under the President's package, the overall limitation would be replaced by a "per country" limitation. This would require companies to calculate a separate foreign tax credit limitation for each foreign country in which income is earned. The allowable credit thus computed could only be used to offset U.S. tax on income from that country.

Treasury seeks to justify its proposal by suggesting that the per country method is consistent with international practice and is necessary to deter excessive tax-motivated investment abroad. It could not be more mistaken. Moreover, this argument reflects a complete misunderstanding of the organization of a modern international business and would impose an unprecedented and unnecessary administrative burden on U.S. firms.

Claims that the per country limitation is the international norm are completely unfounded. The competitive disadvantage which the per country limitation would impose on U.S. companies can be clearly illustrated by the manner in which our principal foreign competitors treat the foreign earnings of their companies. Japan taxes foreign source income with foreign tax credits computed under an overall limitation just as the U.S. does under current law. Foreign source income earned by multinational companies based in Australia, France and the Netherlands is generally exempt from home country tax. Germany (by treaty) and Italy (by dividend exemption) also allow for significant exemption of foreign source income. Belgium exempts most foreign source income, and any foreign source income subject to tax can be offset by foreign tax credits computed under an overall limitation. Even in the United Kingdom and Canada where per country limitations are employed, averaging of high and low foreign tax rates can be achieved via an approporiate foreign corporate structure (i.e., through holding companies). Therefore, if the per country limitation were to be adopted, the U.S. would stand virtually alone in denying its international business the ability to average their foreign tax rates.

According to Treasury estimates, use of the per country limitation will increase U.S. taxes on foreign source income by an average of almost $3 billion a year. This revenue does not arise from taxing previously untaxed income. It arises from denying recognition of a portion of taxes actually paid to a foreign government and thus violates the principle of avoiding double taxation. In the world marketplace, this translates into a $3 billion extra cost of doing business not borne by our foreign competitors. It does not take an expert to see the effect this will have on the ability of U.S. firms to compete abroad. At the margin, American companies will be at a disadvantage and lose market share to

foreign firms which either bear no tax on foreign source income or continue to enjoy the benefit of the overall limitation.

Claims that U.S. foreign direct investment is primarily tax driven are also unfounded. As I noted earlier, American businesses operate abroad to gain access to foreign markets, gain access to raw materials, reduce transportation costs, provide parts and service in foreign markets, meet foreign regulatory requirements, and pierce "protectionist" economic barriers. Tax considerations will do little to change decisions induced by these factors.

This is perhaps best evidenced by the pattern of United States direct investment abroad. According to a recent U.S. Department of Commerce survey, less than five percent of U.S. foreign manufacturing investment -- and less than two percent of U.S. foreign investment overall -- was located in low tax jurisdictions in 1982. Stated otherwise, all but a very small portion of American foreign investment is made in countries with tax rates comparable to or higher than those in the Unites States. In my view, this statistic alone proves the Treasury cannot make the case for "abusive," tax-motivated investment abroad.

The Administration proposal for a per country limitation also reflects a total disregard for the organization of international business. Today's international manager plans and invests at the worldwide level, not country-by-country. The proposed per country rule, however, conceives of the modern international business as a compartmentalized organization, computing profit and loss and effective tax rates on a country-by-country basis. I doubt that this state of affairs has ever prevailed, and it certainly does not prevail today. International boundaries have little business significance in a world where one component of a product may be produced in the United States and another in

France, with warehousing in Belgium, assembly in Germany, and sales in a number of other foreign countries. Pfizer, for example, has organizations in almost 70 countries and sells its products in more than 100 nations.

Because the modern manager plans and invests at the worldwide level, it is the overall foreign tax rate, not each country's individual rate, that has meaning for business purposes. Protection against double taxation requires that foreign taxes, regardless of the country of imposition, be creditable for U.S. purposes up to the point where the overall tax burden of foreign income does not exceed the U.S. tax burden on equivalent domestic income. This is precisely the result provided by the overall limitation. If this level of protection is not provided, American operations abroad are penalized and trade is discouraged.

Congress has recognized this fact since 1921, when it established American policy in favor of an overall credit limitation. Congress has reaffirmed this policy many times since. In 1960, for example, it said:

> In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.

S. Rep. No. 1391, 86th Cong., 2d Sess. ___ (1960).

American international business has become more, not less, integrated in the twenty-five years since Congress made this statement.

Finally, I must point to the unnecessary and burdensome complexity for U.S. businesses and the IRS which will inevitably result from a per country limitation. In my view, it is simply unworkable in a rational way for a company such as Pfizer which sells its products in over 100 countries.

The complexity of the Administration's proposal is magnified by its departure from the global focus of modern accounting practices. Even the most sophisticated of U.S. home offices will need to provide additional personnel and computer resources to perform the large matrices of calculations needed for a country-by-country computation. These additional costs will be serious even for a large multinational operation. They may be crippling for a more modest concern, and the President's proposal may well exclude small corporations from the international market. This is hardly consistent with a sound competitive policy or with the general goals of the President's tax package.

The per country proposal will impose costs on the federal government as well as the private sector. Each of the new allocations required under the proposal will be a potential source of conflict between taxpayers and the Internal Revenue Service. Additional audit personnel will be required to avoid an administrative logjam in the international tax audit process. We can surely find better uses for government revenues than the enforcement of an overwhelmingly complex provision that makes little sense in the first instance.

The Administration itself admits the practical shortcomings of the per country proposal in its own report, which concedes that the per country limitation will impose "significant new burdens on both taxpayers and the Internal Revenue Service." The report on the President's package says specifically:

> Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation. The recordkeeping burdens on taxpayers and auditing burdens on the IRs will be correspondingly increased.

This report is very similar to one delivered by the 1976-77 Ways and Means Committee Task Force by Chairman Rostenkowski. This Task Force recommended exclusive reliance on the overall limitation:

> The per-country limitation requires that a separate computation be made for each country in which a taxpayer operates. Each of these computations requires that taxpayer to calculate the gross income and deductions to be allowed to each country. Since, as discussed above, many large corporations operate on an integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world. The administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group.

Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, 95th Cong., 1st Sess. ___ (1977)

Unfortunately, however, the Administration has failed to heed both its own report and that of the Ways and Means Task Force. We believe this displays a lack of appreciation of the magnitude and importance of administrative burdens. This is not the time to introduce substantial new complexity into the tax laws -- certainly not in the name of simplification and at the expense of U.S. businesses competing abroad.

B. Capital Investment In The U.S. Economy

Pfizer is not a capital intensive company, in the sense of making substantial expenditures for plant and equipment. Other witnesses can speak from greater experience on the impact of the President's package on such investments.

Nevertheless, many ECAT companies believe that serious risks are posed by the President's proposal to repeal the investment tax credit and ACRS depreciation both prospectively (through the adoption of a different capital cost recovery system known as "CCRS") and retroactively (through the newly proposed, so-called "recapture" or "windfall" provision). The likely consequences are reduced levels of capital investment, lower productivity, and the export of both plants and jobs.

The President's proposals are widely perceived as increasing the cost of capital, although a more correctly worded description would be that the proposals increase the cost of certain physical capital investments, including most machinery and equipment. Another concern is the potential adverse effect on many capital intensive companies which could arise from a signficant decrease in cash-flow through the loss of the 10% investment credit and front-loaded depreciation deductions.

In addition to the repeal of ITC and ACRS, the President has proposed a levy on a portion of the depreciation deductions taken since 1980. This "recapture" provision amounts to a retroactive repeal of ACRS for property placed in service between 1981 and 1985, as well as retroactive repeal of ADR depreciation for property placed in service in 1980. This would be accomplished by including a portion of such deductions in a company's taxable income from 1986 through 1988, at the same time that their taxes increase and cash flow decreases as the result of the shift from ITC and ACRS to CCRS. Furthermore, the companies that will bear most of the burden of the prospective repeal of ACRS/ITC are, in general, the same ones which made most of the investment in capital equipment in 1980 and 1985.

The potential problems associated with such a complete change in cost recovery are perhaps most apparent when looked at in the critical international dimension.

An increase in the cost of acquiring capital equipment in this country probably will further impair the ability of many U.S. companies to expand and modernize plants and equipment. This would tend to diminish the international competitiveness of U.S. companies and workers, and further increase the vulnerability of U.S. companies and their employees' jobs to imports. The more favorable cost recovery systems in other industrialized countries may actually provide a positive incentive for U.S. companies to manufacture goods abroad for sale back into the U.S. The result would be a substantially increased trade deficit and a significant loss of jobs.

The international competitiveness issue is more than the issue of where new plants will be built. It is also an issue of whether our plants are sufficiently productive to manufacture goods that can be sold competitively in the world markets. I firmly believe that the relationship between investment and productivity must be given careful consideration before ACRS and ITC are repealed.

However, while the specific proposals affecting the investment credit and ACRS (including the "recapture" tax) are of concern, they cannot be viewed in isolation. There are a number of proposals in the President's package which will have a favorable effect on the overall cost of capital throughout the economy, most notably the substantial reductions in tax rates and the partial deductibility of dividends paid. It is possible that even those industries which would bear a significant increase in the direct cost of investing in machinery and equipment

might also realize a significant decrease in the cost of acquiring the capital -- particularly equity capital -- to make such purchases.

This is a potential effect of the President's overall package which has not yet received sufficient attention. Rate reductions by definition produce a lower cost of capital by reducing the tax bite which the provider of capital -- either an equity shareholder or a debt lender -- must bear on the amount which he is paid for use of his funds. The proposed partial dividend deductibility further lessens the cost of acquiring equity capital by making such payments less costly to the corporations. Reducing the attractiveness of tax-motivated investments in partnership tax-shelters can also encourage new flows of equity capital into the corporate community.

I believe that these effects are likely to be realized from the President's package. Their impact on the overall cost of capital should not be dismissed lightly by those whose primary concerns are specific provisions of existing law which affect certain physical capital.

But the long term impact of these benefits is considerably more difficult to foretell then the readily quantifiable effects of fundamental changes in cost recovery rules. A wholesale change in such rules seems imprudent. I recommend that a more deliberate approach should be taken.

C. Technological Innovation

A final factor affecting U.S. international competitiveness is technological innovation, which has been the source of the U.S. comparative advantage in the past and must be for the future. Our federal tax system can and does have an impact on the willingness of American firms to devote resources to research and development and to the expansion of the U.S. technological base. It is only

through such investments that the U.S. can hope to develop and produce the new and better products and services that will become the source of our competitive edge in the future.

Increasing exports to close the trade deficit ($123.3 bilion in 1984) will most likely depend to a great degree on high-technology products. The United States has become increasingly reliant on high-tech exports. In 1983, high-tech products accounted for about 44% of all exports of manufactured goods, compared to 35% in 1970.

Global competition in R&D is formidable. Although the United States has a large R&D effort in absolute terms, on the basis of its share of Gross National Product devoted to civilian R&D, the U.S. ranks lowest among the big five industrial nations.

Foreign governmental programs call for a continued and stepped up challenge to U.S. civilian leadership in technology. Therefore, although civilian R&D increased by nearly 14% as a percentage of GNP from 1978 to 1983, the share of GNP spent for the same purposes by Germany and Japan rose by 21 and 18.8 percent, respectively. Most industrial nations have aggressive programs to spur private R&D, and Japan has had an R&D tax credit in effect since 1966.

Therefore, the challenge facing R&D-intensive companies, such as Pfizer, is formidable. My company will spend close to $300 million on research in 1985. This is about 3 1/2 times the amount spent 10 years ago. From 1980 to 1984 the pharmaceutical industry as a whole doubled its R&D investments in the United States.

But this is an inherently risky, and very expensive business with many "dry holes" -- and, I might add, a business which is not aided by constant changes in federal tax laws. As such, there is a tendency to underinvest in commerical research.

1. R&D Tax Credit. Recognizing the importance of technological innovation and the problem of underinvestment, the Congress adopted the R&D tax credit in the 1981 Economic Recovery Tax Act to spur industrial research programs. Without further Congressional action, however, the tax credit will expire at the end of this year. The reasons leading to its enactment in 1981 remain with us and, indeed as the discussion below indicates, are intensified.

Until recently, the stimulative effect of the R&D tax credit was not quantified. Using econometric projections, economists at the Brookings Institution and Data Resources Inc. have projected the gain to GNP of a permanent R&D tax credit. Their data include both a very conservative and a "best-case" scenario:

> - Under the most conservative assumptions, a permanent R&D tax credit would generate an extra $1.2 billion a year by 1986 in real GNP and $2.9 billion in 1991.
>
> - Under the "best-case" assumptions, but nevertheless reasonable given past gains from technological breakthroughs, an R&D tax credit would yield $7.5 billion in annual GNP increases in current dollars by 1986 and $17.7 billion by 1991. GNP increases of these magnitudes would produce taxable revenues that more than offset Treasury revenue losses due to the R&D tax credit.

The Treasury Department, in re-evaluating the credit last fall, concluded that an extension of the credit was justified in the context of comprehensive tax reform. In Treasury's November report on tax reform, they commented: "The benefit to the country from...innovation is unquestioned, and there are reasonable grounds for believing that market rewards to those who take the risks of research and development are not sufficient to support an optimal level...."

In a study released in January, the Congressional Research Service took a close look at the same issue and also concluded that lower overall tax rates do not address the problem of chronic underinvestment in R&D. In fact, the CRS

report found that if overall rates are cut, there would be justification for not only retaining but also increasing the R&D tax credit. "(T)he tax rate reductions may actually have a negative impact on R&D investments and justify a retention of an increase in the subsidy," concluded the CRS study.

The R&D credit should be retained as part of any tax reform package. Furthermore, rather than the 3-year extension proposed, it should be made permanent and be expanded to cover basic reasearch by universities and private, non-profit research institutes.

2. Section 861 Regulations. For the purpose of computing U.S. tax liability, section 861 requires corporations with foreign operations to allocate or apportion expenses, losses, or other deductions between domestic and foreign source income. Theoretically, only those expenses directly related to domestic income may be used to offset U.S. income subject to tax and those expenses related to foreign income may be used to reduce foreign income subject to tax by foreign tax authorities. Certain allowable deductions, however, such as R&D expenditures and interest expenses, are not easily allocated between a corporation's domestic and foreign operations. Believing that a portion of this category of expenditure must relate to the generation of foreign income, the Treasury Department promulgated regulations in 1977 establishing complex formulae whereby a part of such overhead expenses would simply be attributed to income earned abroad.

One of the more controversial elements of the 1977 regulations is that Section 1.861-8 requires the apportionment of R&D expenses for foreign operations. The impact of these provisions is to effectively deny U.S. corporations full tax benefits for purely domestic R&D expenses. The proportion thus attributed abroad, however, is frequently viewed as U.S. expense by foreign

tax authorities and therefore is not permitted as a deduction against foreign taxable income. Nevertheless, because such a deduction is used by U.S. tax authorities to reduce foreign source income in the computation of foreign tax credit limitation, it has the effect of reducing the amount of foreign tax credit available and increasing the corporations's overall tax liability. Such adverse tax consequences are felt most acutely by corporations wiht extensive international operations or those engaged in the production of technology-intensive products, and have become a significant incentive for corporations to transfer R&D abroad.

Recognizing the inequities created by the 1977 regulations, the Congress included a provision in the Economic Recovery Tax Act of 1981 imposing a two-year moratorium on the R&D allocation requirements of Section 1.861-8. It also required the Treasury Department to conduct a six-month study of the impact of these regulations on research and development expenditures in the U.S. and the availability of the foreign tax credit. The Treasury Study, released in May 1983, confirmed that Reg. Section 1.861-8 has a disincentive effect on performance of R&D in the U.S. Subsequently, as part of the Deficit Reduction Act of 1984, the Congress extended the moratorium for an additional two years -- through 1985 As as result, this issue will again be open for resolution in this session of the 99th Congress. This time it is hoped that a permanent solution will be achieved. Devotion of resources to R&D is a long-term investment requiring a stable economic environment. Companies will not commit the necessary resources to R&D if they believe their tax treatment will be altered once more in one or two years.

No other country of the world requires the allocation of expenses incurred in the home country to foreign income in order to determine the amount of

foreign tax credit allowable. To the extent that these requirements impose a higher overall tax burden on American corporations, they place U.S. companies at a competitive disadvantage vis-a-vis their international competitors.

Given the adverse tax treatment of American R&D expenditures allocated abroad, it should be no surprise that corporations are tempted to actually move a part of their R&D abroad where it will qualify for full tax deductibility. If one also considers the many other incentives other countries have adopted to foste: technological innovation, the current Section 861 regulations give American management one more reason to tranfer R&D resources abroad.

III. The Business Transfer Tax (BTT) S.1102

Before concluding let me comment very briefly on a proposal that I understand is generating some interest among members of this committee -- the Business Transfer Tax, or BTT, introduced by Senator Roth.

This proposal is presently under study at Pfizer and by other ECAT members. I personally have not had the opportunity to fully study the BTT concept and therefore am not in a position to discuss it in any detail. Nonetheless, I believe it is a proposal that should be weighed very carefully in the current tax reform debate.

As you know, it is similar in concept to the value added tax system utilized in Western Europe. Over the years, there has been considerable debate over whether the United States should move to such a system, thereby harmonizing its tax structure with many of the United States principal trading partners. Such debate is healthy and should continue with particular focus on its potential impact on the United States' current trade problems. As ECAT's own review of the BTT proposal is completed, it will be pleased to share its recommendations with you.

Conclusion

Let me just reiterate my belief that tax simplification of the nature proposed by the President cannot be achieved without costs -- perhaps substantial ones to certain sectors of our economy. Therefore, I would urge great caution. In my view, we must be far more aware of the impact of this proposal on our domestic economy and the ability of American business to compete abroad before enacting it into law. I have only pointed to a few of the provisions of most direct impact on international business; however, I hope you give these thoughts your most careful consideration.

STATEMENT OF LARRY R. LANGDON, DIRECTOR OF TAXATION AND DISTRIBUTION, HEWLETT-PACKARD CO., PALO ALTO, CA

Mr. LANGDON. My name is Larry Langdon. I am director of taxation and distribution of Hewlett-Packard Co. of Palo Alto, CA, a designer and manufacturer of measurement and computational products and system. Overal, HP views President Reagan's tax proposals favorably. We support the proposed changes in the domestic provisions of the Internal Revenue Code which, in our view, will increase the ability of U.S. business to compete in international markets. We particularly favor the proposed reduction of income tax rates, the extension of the R&D tax credit, the proposal for an accelerated depreciation system that benefits short as well as long lived business assets, relief from double taxation of dividends, and indexing of business inventories. We are, by the way, members of ECAT [Emergency Committee on American Trade], and we support their position with regard to international provisions, but we understand the focus of this debate is the domestic provisions of the President's proposal.

Because of the competitive dynamics of the high technology companies must invest the major porition of their resources in research and product development in order to remain competitive. The expense of R&D efforts to develop new generations of products is sufficiently high that each generation of products must be sold in the broadest possible marketplace to provide sufficient revenues to continue funding future product generations. As a result, it is essential for U.S. companies to sell their products competitively in foreign markets. The importance of competitiveness in world markets is reflected both in our large exports—HP is the seventh largest U.S. exporter—and our significant foreign manufacturing activities. HP currently manufacturers in 10 foreign countries, has entered into the manufacturing joint ventures in 3 other countries, and has sales and support offices in approximately 40 countries. Over 42 percent of our sales are outside the United States, while only 20 percent of our manufacturing is done outside the United States; and 92 percent of our R&D is in the United States.

We would refer to the conclusions of the President's Commission on Industrial Competitiveness, which was chaired by John Young, our president and chief executive officer.

The five key tax legislation recommendations of that Commission are:

(a) Reducing the bias against savings and investment through elimination of double taxation of corporate profit;

(b) reducing the variance in effective tax rates on different industries which results from their receiving varying credits and depreciation allowances on different kinds of assets;

(c) providing inflation adjustments for capital income and capital expense or loss items similar to existing income tax indexing;

(d) reducing disincentives to venture and other risk capital investments; and

(e) broadening the tax base by including more income items and reducing the number of tax deductions and exclusions.

HP supports the President's proposal to reduce the maximum corporate marginal rate to 33 percent and to broaden the tax base

by including more income and reducing deductions and credits. We see several benefits from this.

First, economic efficiency would be promoted.

Second, competitiveness of U.S. high-technology electronics manufacturers will be enhanced by alleviating some of the disproportionate burden placed on them under the current tax system.

Three, profits and goods manufactured in the United States and exported abroad will enjoy a competitive tax rate compared to our major trading partners.

The President's proposal recommends the R&D tax credit be extended and its definition be focused on truly innovative activities. Incentives for investment in private sector research are critical to this nation's worldwide technological leadership. The extension of the R&D tax credit will provide incentives for U.S. companies to commit additional resources to research and innovation, which will lead to the development of new products and will enable U.S. companies to compete in the international marketplace.

The President's proposals will also provide reasonable incentives for U.S. companies to invest in capital equipment. Although they will not provide the same incentives for capital investment as the current combination of ITC and ACRS, the proposals will be more neutral among industries so that capital will be allocated among industries based more on economic than tax considerations. While the windfall depreciation provisions contain a strong conceptual basis, there are a couple of structural flaws that need correction. If these structural flaws are corrected, we believe the recapture provision will be more acceptable to the business co—unity. The current tax system encourages corporations to rely too heavily on debt rather than equity. The proposal for a 10-percent dedution for dividends paid will help market forces to channel capital to those enterprises that make the best use of it, and we support this provision.

The President's proposal recommends taxpayers be permitted to index inventories for inflation, which will permanently remove inflationary gains in the tax base and enhance international competitiveness. Finally, the President's proposal in total is generally viewed as revenue neutral. It is very important to U.S. exporters that the current Federal deficit not be increased and ideally be reduced in order to keep U.S. products competitive. The continually strengthening U.S. dollar has had the most adverse impact on the ability of U.S. companies to export. Thus, the efforts of this committee in keeping the deficit under control by balanced tax reform will greatly help international competitiveness. Thank you.

The CHAIRMAN. Thank you very much. Dr. Mauer.

[The prepared written statement of Mr. Langdon follows:]

Before the

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

Statement of

LARRY R. LANGDON

DIRECTOR, TAX AND DISTRIBUTION

HEWLETT-PACKARD COMPANY

July 18, 1985

INTRODUCTION

My name is Larry R. Langdon. I am Director, Tax and Distribution of the Hewlett-Packard Company of Palo Alto, California.

Hewlett-Packard is a designer and manufacturer of more than 7,000 measurement and computation products and systems. During its last fiscal year, Hewlett-Packard Company and its subsidiaries had sales of over $6 billion, about 42% of which were to customers outside of the United States. HP has over 84,000 employees worldwide, of whom about 56,000 work in the United States. Worldwide capital expenditures last year were $661 million and worldwide R&D expenditures were $592 million.

PROPOSITION UNDER DEBATE

Does the President's Tax Reform Proposal deminish the ability of United States business to compete in international markets? Hewlett-Packard would take the con position to this proposition. We believe the President's Tax Reform Proposal, taken as a whole, will increase the ability of United States business to compete in international markets.

SUMMARY OF POSITION

Overall, HP views the President's proposals favorably. We are particularly in favor of the proposed reduction of income tax rates and the extension of the R&D tax credit. The President's proposals will encourage Americans to increase their savings and investment by substantially reducing income tax rates. Further, by reducing the disparities in effective tax rates among different industries, the proposals will lead to a more efficient allocation of investment resources throughout the economy. This will lead to a stronger U.S. economy with greater employment opportunities.

INDUSTRIAL COMPETITIVENESS

To confirm the position that the President's domestic tax proposals will enhance the ability of U.S. business to compete in the international marketplace, I refer to the President's Commission on Industrial Competitiveness which completed its work last December. The Commission was chaired by John A. Young, who is President and Chief Executive Officer of HP.

The Commission made five key recommendations for restructuring the tax system which it felt would greatly enhance the ability of American business to compete on a global basis.

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"(a) Reducing the bias against savings and investment through elimination of the double taxation of corporate profit;

"(b) Reducing the variation in effective tax rates on different industries that results from their receiving varying credits and depreciation allowances on different kinds of assets;

"(c) Providing inflation adjutments for capital income and capital expense or less items, similar to existing income tax indexing;

"(d) Reducing disincentives to venture and other risk capital investments; and

"(e) Broadening the tax base by including more income items and reducing the number of tax deductions and exclusions...."

(Report of the President's Commission on Industrial Competitiveness, pp. 28-29)

An important conclusion was that all of these areas are important; there is not just one critical area than can assure U.S. industrial competitiveness. As Congress considers the President's tax proposals every effort must be made to ensure that the laws are amended to enhance U.S. industrial competitiveness. Conversely, care must be taken to avoid those provisions that, by design or inadvertently, will make it more difficult for U.S. companies to compete in international markets.

INTERNATIONAL SCOPE OF OPERATIONS

Because of the competitive dynamics of the high technology electronics industry, companies such as HP must invest a major portion of their resources in research and product development in order to remain competitive. The expense of

R&D efforts to develop new generations of products is sufficiently high that each generation of products must be sold in the broadest possible marketplace to provide sufficient revenues to continue funding future product generations. As a result, it is essential for U.S. companies to sell their products competitively in foreign markets. If, for whatever reasons, U.S. companies are not competitive in foreign markets, their foreign counterparts will obtain the broader earnings base needed to finance larger R&D activities and will be able to develop future generations of competitively superior products for sale in the United States as well as in foreign markets.

U.S. high technology electronics companies gain access to foreign markets through both direct exports and foreign manufacturing and sales operations. Even relatively small U.S. high technology electronics companies engage in significant exports. Among a group of smaller electronics companies, for example, export sales comprised 21.6% of total sales in 1981 ("High Technology Tax Policies for the 1980's, Report of the Ad Hoc Electronics Tax Group, January, 1984, p. 11). Larger companies, such as HP, are also substantial exporters, as illustrated by HP's ranking as the 60th largest U.S. industrial company based on revenue (Fortune, April 29, 1985 issue), and as the 7th largest U.S. industrial exporter (Business Week, March 22, 1985). In 1984, HP's U.S. exports totalled approximately $1,420,000,000.

The world export market is highly competitive. In a 1983 study the U.S. Department of Commerce concluded that the international market share of U.S. high technology electronics companies has been declining over the past twelve years and that international competition is growing every year. Indeed, intense foreign competition, most notably from the Japanese, has resulted in a recent slump in the high technology electronics industry and the loss of many U.S. jobs. Countries, such as Japan, provide their exporters with a variety of direct and indirect tax

subsidies. Recognizing the importance of U.S. exports to the U.S. economy and employment, Congress in 1984 enacted the Foreign Sales Corporation provisions to help U.S. exporters compete on a fairer basis with their subsidized foreign competition. HP and other high technology electronics companies support these provisions as an appropriate and necessary means to encourage U.S. industries dependent on exports.

The implications of the large export and international operations of U.S. high technology electronics companies for U.S. tax policy are clear: for high technology companies the U.S. tax treatment of U.S. exports and the foreign operations of U.S. taxpayers is of fundamental importance. Without question, these rules can and do have a dramatic effect on the ability of U.S. companies to compete in international markets and, therefore, on the survival and prosperity of the industry in every market. Given the need for U.S. corporations to be competitive in world markets, it is in this country's interest not to subject its corporations to a system of taxation that is substantially more restrictive than is faced by major foreign competitors. The President's proposals as a whole would encourage greater and more productive domestic investment. As indicated by the analysis that follows.

LOWER RATES, BROADER BASE

HP supports the President's proposal to reduce the maximum corporate marginal tax rate to 33% and to broaden the tax base by including more income and reducing deductions and credits. We see several benefits that will result.

First, economic efficiency will be promoted. By eliminating the wide variation of effective tax rates from industry to industry, our capital resources will flow according to the market without being unduly influenced by tax considerations. Second, the competitiveness of U.S. high technology electronics manufacturers will be enhanced by alleviating some of the disproportionate burden placed on them under the current tax system. Third, the profits on goods manufactured within the United States and exported to the U.S. major trading partners will enjoy an effective corporate tax rate as low or lower than the effective corporate tax rate of those major trading partners.

RESEARCH AND EXPERIMENTAL TAX CREDIT (R&D CREDIT)

The President's proposal recommends that the R&D credit be extended and that its definition be focused on truly innovative activities. HP supports this proposal and strongly recommends that this important incentive be made permanent. If a short-term expiration date were to continue, as in current law, companies could not depend on the credit for the duration of many R&D projects. Typically, these projects, especially the riskier ones with the largest potential pay-offs for the country, require five or more years to develop a marketable product. To be most effective, the term of the credit has to accommodate the long-term nature of the undertakings it is aimed at stimulating. Congress has recognized the need to make this credit permanent in the 1984 Senate bill renewing the credit and in H.R. 1188, which is now pending before the House and has more than 200 cosponsors.

Incentives for investment in private sector research are crucial to this nation's worldwide technological leadership. The retention of this accurately focused and efficient incentive will be beneficial to high technology and other industries, while giving the country an excellent return on its investment in research activities.

The extension of the R&D tax credit will provide incentives for U.S. companies to commit additional resource to research and experimentation, which will lead to the development of new products that will enable U.S. companies to compete in the international marketplace. Due to the length of many R&D projects, however, HP favors making the R&D credit permanent, rather than extending it for just three years.

CAPITAL ASSETS, WINDFALL DEPRECIATION RECAPTURE

The President's proposals also provide reasonable incentives for U.S. companies to invest in capital equipment. Although they will not provide the same incentives for capital investment as the current combination of ITC and ACRS, the proposals will be more neutral among industries, so that capital will be allocated among industries based more on economic than tax considerations.

Replacing ITC and ACRS with a Capital Cost Recovery System (CCRS) indexed for inflation is sound in principle. The treatment of most high technology equipment is rational and generally supportable, even though the classification of general types of high technology equipment, principally electronic manufacturing equipment, needs to be refined.

Many have argued that the "windfall" depreciation recapture provisions are unfair. HP feels that there is a conceptual basis for these proposals and supports them as part of the entire proposal subject to the correction of two structural flaws. These are:

1. It should be made clear that assets disposed of prior to July 1, 1986 are not considered in computing the tax. Without such clarification, recapture would be completely unfair since the sale of the

asset would have already been taxed at 46%. Recapture would be based on a non-existent windfall.

2. It is a mistake to base recapture on assets lives which do not reflect reality. The current proposal arbitrarily attributes a life of 12 years to many of HP's assets which are depreciated five years. These assets have an economic life very close to this five-year depreciable life. If the arbitrary 12-year life is not modified - possibly using RCRS with classification refinements or financial statement depreciation - the recapture calculation would be based on accelerated depreciation which did not exist.

In addition, HP feels that recapture should be phased over a longer period to reduce its significant negative cash flow effect on capital intensive industries. With these conditions, the recapture provisions should receive strong support from the business community.

RELIEF FOR DOUBLE TAXATION OF DIVIDENDS

The double taxation of dividends in the current tax system has led to several undesirable effects. It encourages corporations to rely too heavily on debt, rather than equity. Highly leveraged businesses tend to be too concerned with short-term results and are more vulnerable to bankruptcy during business downturns. The double taxation of dividends also creates inducement for firms to retain earnings, rather than pay them out as dividends. This provision will help market forces to channel capital to those enterprises that will make the best use of it. Accordingly, HP supports the proposal to establish a 10% dividends paid deduction and urges that the deduction be increased in the future.

INDEXING INVENTORIES

The President's proposal recommends that taxpayers be permitted to index inventories for inflation. This responds directly to the concept that taxes should be imposed on real economic income, not on increases that are attributable to inflation. The proposal will permanently remove inflationary gains from the tax base and will enhance the international competitiveness of American business.

INTERNATIONAL PROVISIONS

Even though the international provisions of the President's Tax Reform Proposal are not the subject of this debate, the international provisions may be discussed as part of the international competitiveness issue. These provisions focus on potential incongruities that could result under existing rules following a reduction of the corporate tax rate from 46% to 33%. The proposed treatment of international operations, particularly (i) the change from an overall to a per country limitation in the foreign tax credit computation; (ii) changes in the "source of income" rules; (iii) the failure to propose that the moratorium on the allocation of R&D expenses under Treasury Regulations section 1.861-8 be made permanent; and (iv) changes in the possessions tax credit, will have a negative impact on the competitiveness of U.S. companies in the international marketplace and will unnecessarily complicate an already complex but well-established set of tax rules. These proposals create inequities and complexity which go beyond the issue of the 46%/33% rate differential. Accordingly, we strongly recommend that the international provisions of the proposal be studied further and a more equitable, simpler proposal be developed by this committee. However, in spite of these limitations which may be corrected in legislation process, we can support the President's proposal on an overall basis regarding its impact on international competitiveness of domestic operations which manufacture for worldwide markets.

STATEMENT OF LAURENCE J. MAUER, PH.D., ASSOCIATE PROFESSOR, ST. JOHN'S UNIVERSITY, NEW YORK, NY

Dr. MAUER. My name is Laurence Mauer. I am an associate professor in the Economics and Finance Department at St. John's University in New York City. I am here to take the position that the President's tax reform proposal will diminish the international competitive position has deteriorated sharply since 1980, largely due to the rising value of the U.S. dollar in foreign exchange markets. The impact of this has been on a range of industries and on a range of regions within the United States, concentrated by and large in the industrial belt section of this country. The result has been a substantial loss of jobs and lack of job growth—employment growth—in these States. Against this backdrop, the Congress is now considering a tax package which, in its broadest terms, has the effect of reducing taxes on households and paying for this by increasing taxes on businesses through repealing the ITC, ACRS, capital recovery provisions, through a windfall profits tax, and certain other provisions. This tax package mix willhave the effet of placing U.S. companies at a competitive disadvantage in export markets abroad, but more importantly, this tax package will have the effect of placing U.S. companies at a competitive disadvantage in their domestic markets here in the United States. This erosion in the U.S. competitive position is unlikely to be offset by a decline in the U.S. dollar's value. The exchange value of the dollar in recent years has been dominated by powerful macroeconomic forces, such as high real interest rates which have been associated with the large structural Federal budget deficit or deficits. And the proposed tax reform package, which we are discussing, is at least intended to be revenue neutral, that is, not designed to reduce those deficits. The effect of the erosiion in the U.S. competitive position, should tnis legislation be adopted, will be to cause a further loss of jobs in the United States. These job losses will fall most heavily in the U.S. industrial sector, which presently already suffers from severe foreign competition, both here and abroad. One alternative approach to this--in effect, a heavier taxing of the business sector--would be to finance the tax changes proposed for the household sector in the President's bill through legislation adopting taxes tha fall more heavily on consumption, such as the border adjustable consumption tax.

The CHAIRMAN. Dr. Makin.

[The prepared written statement of Dr. Mauer follows:]

THE PRESIDENT'S TAX REFORM PROPOSAL WILL DIMINISH THE INTERNATIONAL COMPETITIVE POSITION OF AMERICAN INDUSTRY

TESTIMONY BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

July 18, 1985

by

Laurence J. Mauer

Associate Professor of Economics

St. John's University

New York City, New York

THE PRESIDENT'S TAX REFORM PROPOSAL WILL DIMINISH THE INTERNATIONAL COMPETITIVE POSITION OF AMERICAN INDUSTRY

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SUMMARY

This presentation is an analysis of the effects of the Treasury II tax proposal on the international competitive position of business firms in the United States. The main emphasis is on the ways in which the U.S. economy will be adversely affected by repeal of the Investment Tax Credit and the ACRS method of depreciation.

The Treasury II proposal will contribute to a deterioration in U.S. international competitiveness in the following ways:

- It will raise taxes and other costs associated with the capital recovery system in the United States in comparison with other countries.
- These increased costs will place U.S. companies at a competitive disadvantage in export markets abroad and also in their domestic markets in the United States. The result will be a loss of jobs in the U.S.
- These additional competitive pressures will fall most heavily on the U.S. industrial sector, which presently suffers from severe foreign competition both at home and abroad.

An alternative to repealing the ITC/ACRS capital recovery system would be to adopt a border-adjustable consumption tax.

I. Introduction

The United States has enjoyed a vigorous economic expansion during the past 2 1/2 years. However, this expansion concealed sharply divergent trends within the economy. Over the period, the service sectors, construction, and high-tech areas have made strong growth showings. At the same time, the nation's industrial sector has remained under considerable pressure from foreign-based competitors both in the U.S. and in export markets. The principal explanation for the sharp divergence between the industrial sector and the rest of the economy has been the serious erosion in the U.S. international competitive position which has taken place in recent years.

The U.S. Congress is now considering the tax reform program identified as the President's Tax Proposals for Fairness, Growth, and Simplicity (Treasury II). There are many favorable tax system changes included in the President's plan. However, the Treasury II program also proposes to change the nation's capital recovery system in ways which will contribute to a further erosion in the nation's international competitive position.

The comments offered in this testimony are focused on the question of the effects of the Treasury II tax reform proposal on the U.S. international competitive position. It is argued here that the capital recovery provisions of Treasury II will contribute in a major way to an erosion of U.S. competitiveness, both in foreign markets and in

domestic U.S. markets. The implications of this erosion for the U.S. economy is also examined. Finally, suggestions are offered of alternative ways to achieve fiscal policy objectives without contributing to an erosion of U.S. competitiveness.

II. Where We Now Stand and How We Got This Way

The U.S. competitive position in international trade has deteriorated sharply since 1980. The principal force behind this erosion has been the rising value of the U.S. dollar in foreign exchange markets. The dollar, on a trade-weighted basis, has risen by more than 40% over the past four years, as illustrated in Exhibit I. Associated with this change has been a corresponding decrease in the dollar's value measured against the exchange values of the currencies of virtually all other industrialized countries as seen in Exhibit 2.

The dollar's protracted rise over this period occurred largely in response to the emergence of high real interest rates in the U.S. relative to those in other nations. These high U.S. interest rates, in turn, were in large part due to the high Federal government budget deficits that have prevailed in recent years.

The dollar's rise has caused the U.S. trade account to swing from a position of near equilibrium in 1979-80 to an enormous $120 billion deficit in 1984, as shown in Exhibit 3.

These developments already have dealt a severe blow to the nation's manufacturing sector. Merchandise trade exports, shown in Exhibit 4, have not yet recovered from the 1981-82 recession and are still well below their 1980 levels. The greatest weakness in exports has been concentrated in manufactured goods. At the same time, and also shown in Exhibit 4, U.S. merchandise imports have soared, led by imported manufactured goods. Imports are now more than 30% above 1980 levels.

These data, show that the erosion in the U.S. international competitive position in recent years has become a problem of national importance. As indicated in the exhibits above, the problem is not so much the poor export performance of American firms in foreign markets. Rather, it is the surge in imports that threatens U.S. manufacturers in their home markets.

There has been a substantial loss of jobs as a result of this adverse competitive position. From a national standpoint, econometric studies have estimated these job losses to be in the 2 million range. These job losses have been concentrated in a number of the nation's basic manufacturing industries which have yet to attain their pre-recession (1979) levels of output. A partial listing of these industries is presented in Exhibit 5.

Moreover, these industries tend to be geographically concentrated in the nation's Midwestern region. In 17 states, as listed in Exhibit 6, total employment has yet to recover to the levels that prevailed in late 1979

despite the general increase in employment for the nation as a whole. When the manufacturing sector alone is considered, fully 41 states have yet to regain their 1979 employment levels, as seen in Exhibit 7.

III. Treasury II Will Worsen U.S. Competitiveness

The President's tax reform proposal affects U.S. competitiveness mainly by raising the cost structure of companies producing goods and services in the United States, relative to their foreign-based competition. These higher costs result from increased taxes directly and from increases in capital costs brought about by changes in the tax code. Among the provisions which raise the costs of U.S. firms are the following:

- Repeal of the Investment Tax Credit
- Replacement of the Accelerated Capital Recovery System (ACRS) by the less generous Capital Cost Recovery System (CCRS), coupled with a partially offsetting reduction in the corporate tax rate to 33% from its current 46% level.
- The "windfall recapture" tax transition rule.

Implications for Competitiveness: Medium-Term

The effect of the Treasury II provisions has been estimated by the U.S. Treasury to raise the corporate tax bill in the U.S. by nearly 25% over the first five years under the President's proposed tax program. Under

currently maintained economic assumptions, this tax burden would be somewhat smaller than under present tax rules beginning in the 1990s. But an adverse period of five years would do serious damage to the viability of the U.S. corporate sector. During that time, the drain on corporate cash flows due to higher tax payments would imply a considerable erosion in the international competitive position of U.S. industry.

Abstracting from the "windfall recapture" tax and subsidiary Treasury II provisions, the ITC/ACRS capital recovery program and that of CCRS under the Treasury Plan can be compared to determine their effects on business costs and cash flows. For purposes of this comparison, our focus is the present value of investment allowances under ITC/ACRS and CCRS. This comparison is presented in Exhibit 8 which shows the treatment under the two plans for representative assets in each of the CCRS asset classes. As indicated in the Exhibit, the ITC/ACRS system provides more generous treatment than the Treasury plan for all five equipment asset classes under conditions of inflation up to 10% (8% for the public utility asset class). In the case of factory structures, CCRS would provide about the same tax deductions as ITC/ACRS at today's inflation rate.

As indicated above, the costs borne by U.S. firms will be higher in comparison with current tax provisions whether considered from the standpoint of the overall Treasury II program (including the windfall profits tax and subsidiary provisions) or from the more limited standpoint of the valuation of investment allowances. If Treasury II is enacted, this rise in costs will result in a reduction in the international competitiveness of U.S. businesses.

An indication of the extent of the erosion in the U.S. competitive position can be gained by a comparison of the after-tax cost of capital in the United States relative to the cost in other nations, as presented in Exhibit 9. Under current law, the after-tax cost of capital in the U.S. is among the lowest of the major industrial countries. Whereas, under the Treasury proposal, it would be among the highest.

Implications for Competitiveness: The Long Run

From a longer term standpoint, economy-wide considerations must be evaluated in judging the impact of Treasury II on the U.S competitive position. Here it is necessary to gain a perspective on changes in the resource flows which occur under Treasury II. In the broadest sense, Treasury II aims to achieve a substantial reduction in the tax burden on households through a reduction in personal tax rates. To retain overall revenue neutrality, the plan makes up for revenue losses in the household sector by raising tax revenues from the business sector. One of the ways in which this is done is by substituting CCRS for the current ITC/ACRS provisions.

Under CCRS, business firms would be required to depreciate capital assets at rates that at least theoretically would be in line with the "economic life" of those capital assets. (The practical workability of this proposition hinges on the ability of Treasury bureaucrats to correctly specify "true economic lives"; I personally doubt that this can be satisfactorily done by Treasury over time in a dynamic and technologically changing economy.)

The pursuit of the objective of tax neutrality in this sense is desirable and, if achieved, would result in efficiency gains in the economy. Of much greater importance, however, is the objective of achieving a better balance between consumption and investment.

Several studies indicate that the U.S. economy is biased toward consumption at the expense of investment, and that these distortions are several times more serious than distortions among specific asset classes under ITC/ACRS.[1] Under these circumstances, the broad impact under Treasury II of cutting personal taxes while raising taxes on business must be interpreted as contributing further to the consumption-investment imbalance, thus swamping the efficiency gains from "tax neutrality". Should it be adopted, Treasury II would raise business costs in the economy as a whole on balance. The replacement of ITC/ACRS with CCRS would impose unusually large cost increases on the capital intensive companies. Recognizing that the capital intensive companies are predominantly represented in the manufacturing (internationally traded goods) sectors, this increase in costs would have the effect of reducing, pari passu, the international competitiveness of U.S. firms.

Consequences of a Deterioration in International Competitiveness

As indicated in this section, enactment of the Treasury II U.S. capital recovery system will have the effect of raising the cost structure of

[1] M. Boskin, "Taxation Saving and the Rate of Interest", Journal of Political Economy, April 1978; and D. Fullerton, J. Shovern, and J. Whalley, "Gains from Replacing the U.S. Income Tax with a Progressive Consumption Tax", Journal of Public Economics, 1983.

U.S. firms relative to the costs of foreign companies, in effect, producing a deterioration in the U.S. international competitive position. This will come at a time of already severe international competitive pressures on U.S. manufacturing companies from the dollar's protracted rise over the past five years. A further erosion in competitiveness will result in further increases in imports to the U.S., a continued pattern of "no-growth" exports, and a shift in U.S. direct investment to off-shore locations as U.S. companies attempt to get into more favorable production cost environments. The consequence of these developments will be a further loss of jobs in the U.S., which will tend to be concentrated in those industries and states which have not yet fully recovered from the 1981-82 recession, and which continue to be held back by the strong dollar.

In the long run, jobs lost in manufacturing will tend to be absorbed in the service sectors of the economy. The transition, however, also is slow and painful. Moreover, this shift in the composition of employment would be very costly to the economy. One reason is that wages in the service sectors, on average, are considerably lower than in manufacturing. Therefore, a substitution of service jobs for manufacturing will result in a lower average wage level for the economy as a whole. Another reason is that the transition will create "structural" unemployment which is costly in terms of lost income, tax revenues and outlays for unemployment compensation.

Although services have been growing in importance in the American economy throughout the postwar decades, this has been a gradual process which has allowed time for adjustments to take place. The sweeping changes that have occurred since 1980 have already imposed extraordinary adjustments on the industrial sector. With the removal of ITC/ACRS, the shift from manufacturing to services would be accelerated, possibly to the point where the adjustment mechanisms would become overloaded, particularly in the industrial regions of the country. A strong industrial sector is a necessary element for a growing economy. For these reasons, repeal of ITC/ACRS potentially could do long-run structural damage to the U.S. economy.

IV. Will the Dollar Decline to Offset Higher Costs Under Treasury II?

Traditional theory in economics suggests that over the long run, an increase in the cost structure of one country relative to its trading partners will set into motion forces which bring about a fully offsetting depreciation in the exchange rate for that nation. This view is called the purchasing power parity theory.

While this theory may be applicable over very long periods of time -- decades perhaps -- it has been clear since the late 1970s that broad macroeconomic forces can also be powerful determinants of exchange rates. Thus, high real interest rates in the U.S. in recent years have contributed to the dollar's progressive strength, resulting in as much as 40% to 50% overvaluation when judged on a purchasing power parity basis.

A second force contributing to the dollar's strength has been the shift in portfolio preferences by foreigners to the U.S. dollar as a safe haven currency asset.

The forces that contribute to high real interest rates in the United States are expected to continue for the foreseeable future. Foreigners' asset preferences, speculation aside, are also unlikely to shift dramatically against the dollar. Therefore, these forces can be expected to dominate the dollar exchange rate for some years to come.

Under these circumstances, the cost increases associated with Treasury II and identified in the previous section of this testimony will not be fully offset by a decline in the U.S. dollar's foreign exchange value. At least over the next five years, we can expect the higher business costs associated with Treasury II to be absorbed in the form of a deterioration in U.S. competitiveness. This erosion in competitiveness will be felt by U.S. companies both in export markets and in their domestic markets in the United States.

V. An Alternative Approach

Apart from the changes in the capital recovery provisions and their implications, I find myself in substantive agreement with the major directions of the Treasury II tax plan. It is desirable to further reduce (and simplify) personal tax rates, to streamline the tax code, and to reduce (or eliminate) the tax burden on the poor. But, the tax revenue losses which are incurred in achieving these objectives should not be made up in ways which lead to an erosion in the nation's international competitive position.

An alternative approach would be to adopt a form of border-adjustable consumption tax or a modified form of the Value Added Tax (VAT).[2] Under these tax systems, the amount of the tax on specific export products is rebated at the border, permitting those goods to be exported more competitively in international trade. Under the General Agreement on Tariffs and Trade (GATT), a country may adjust the price of an exported item by the amount of indirect taxes, but not for direct taxes such as income taxes and social security taxes. At present, because border tax rebates occur under the VAT, goods from the EEC have a competitive advantage over goods produced in the United States which bear the cost of high income and payroll taxes.

2. The VAT is presently in use in all of the member nations of the European Economic Community and approximately 12 other nations outside of the socialist bloc.

Tax revenues given up in the achievement of fairness and efficiency toward the household sector under Treasury II could be replaced by instituting a modest national consumption tax on the order of 1% or 2%, with exemptions on appropriate purchase classes such as food, clothing, medicines, etc. A modification in this direction would be neutral with respect to investment decisions and would be beneficial from the standpoint of the nation's international competitive position.

An alternative to the border-adjustable consumption tax, and one with possibly greater compatibility with current U.S. legislation, is the Business Transfer Tax (BTT) proposal which has been advanced by Mr. E. G. Jefferson of DuPont. The BTT would allow a FICA credit and would, like the VAT, exempt exports. A border tax would be placed on imports at the same rate as the BTT on U.S. production.

VI. Concluding Remarks

This testimony has established that the international competitive position of U.S. firms has eroded to an extremely low level in recent years. The effects of this erosion have been unusually severe in the economy's industrial sectors. Moreover, it has been established that, over the next five years, the Treasury II provisions related to capital recovery would bring about a substantial rise in the tax burden of U.S. firms. This rise in business costs will result in a further deterioration in international competitiveness for U.S. business, which would be concentrated in the already hard-hit industrial sectors. Under these

circumstances, it would not be fair or efficient in an economic sense to alter the tax code to repeal the ITC/ACRS capital recovery system and to replace those provisions with the less appropriate CCRS system.

It is desirable to reduce marginal personal tax rates, to streamline the tax code and to ease the tax burden on the poor. However, to make up the revenue losses from these tax changes by raising taxes on the business sector would seem counterproductive. Such actions threaten the nation's international competitiveness and could have serious adverse effects on productivity and economic growth. As an alternative approach, the President and the Congress should give serious consideration to adopting a form of border-adjustable consumption tax.

Exhibit 1

THE U.S. DOLLAR HAS STRENGTHENED BY MORE THAN 40% SINCE 1980

Exhibit 2

WHILE CURRENCIES OF OTHER INDUSTRIAL COUNTRIES HAVE FALLEN

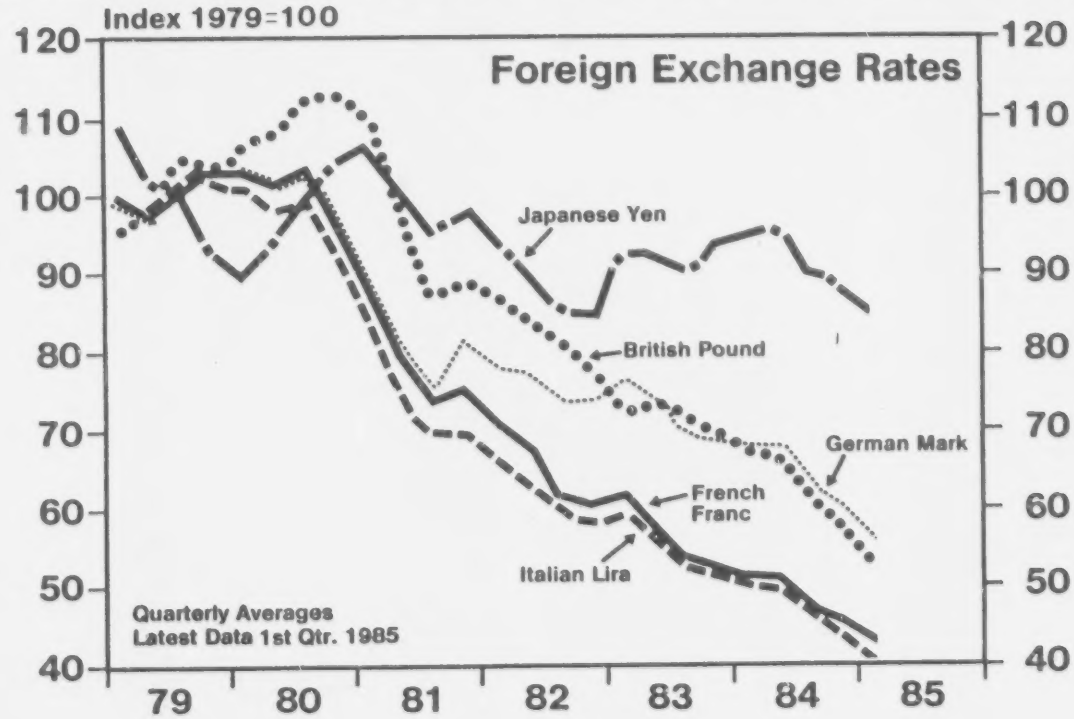


Exhibit 3

U.S. TRADE DEFICIT HAS INCREASED DRAMATICALLY

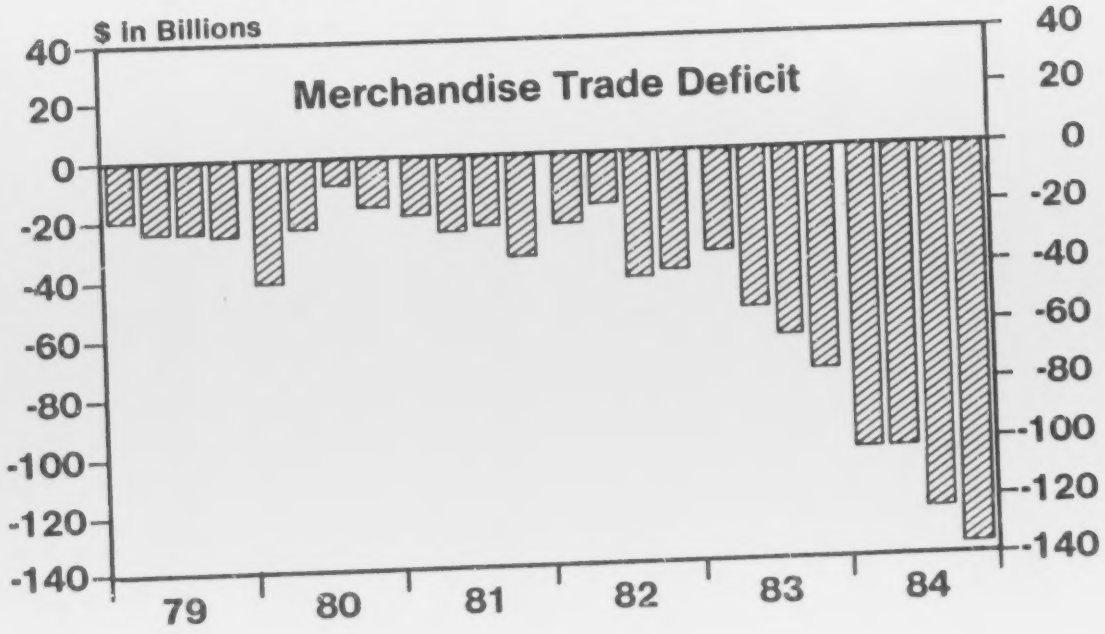


Exhibit 4

SOARING IMPORTS, NO-GROWTH EXPORTS

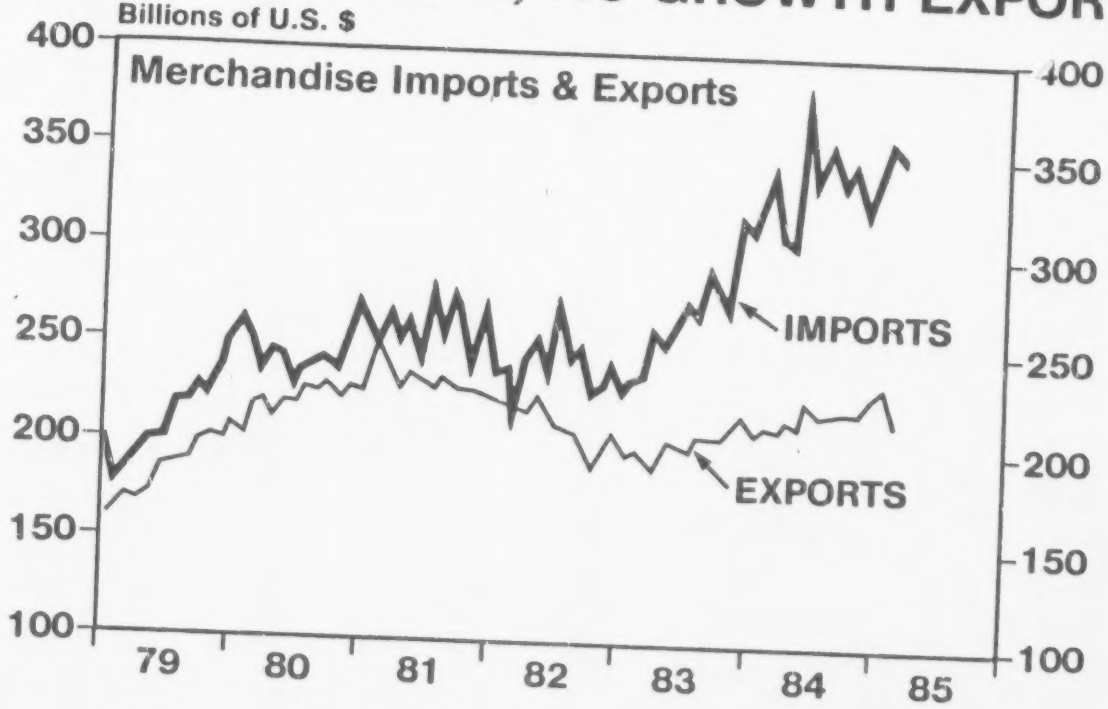


Exhibit 5

INDUSTRIAL PRODUCTION STILL BELOW 1979 LEVELS FOR MANY INDUSTRIES

Industries That Have Not Yet Recovered Fully From 1981-82 Recession

- Mining
- Nonferrous Metals
- Iron and Steel
- Farm Equipment
- Transportation Equipment
- Petroleum Refining
- Leather
- Clay, Glass, Stone
- Fertilizer
- Hardware
- Machine Tools
- Agriculture, Forestry
- Railroad Facilities
- Utility Facilities
- Construction
- Textile Mill Products
- Building Paper & Board Mills
- Organic & Inorganic Chemicals
- Synthetic Rubber
- Metal Samplings
- Construction Machinery
- Industrial Trucks & Tractors
- Rolling Mill Products
- Electric Lamps

Exhibit 6

TOTAL EMPLOYMENT STILL BELOW 1979 LEVELS IN 17 STATES

Exhibit 7

MANUFACTURING EMPLOYMENT STILL BELOW 1979 LEVELS IN 41 STATES

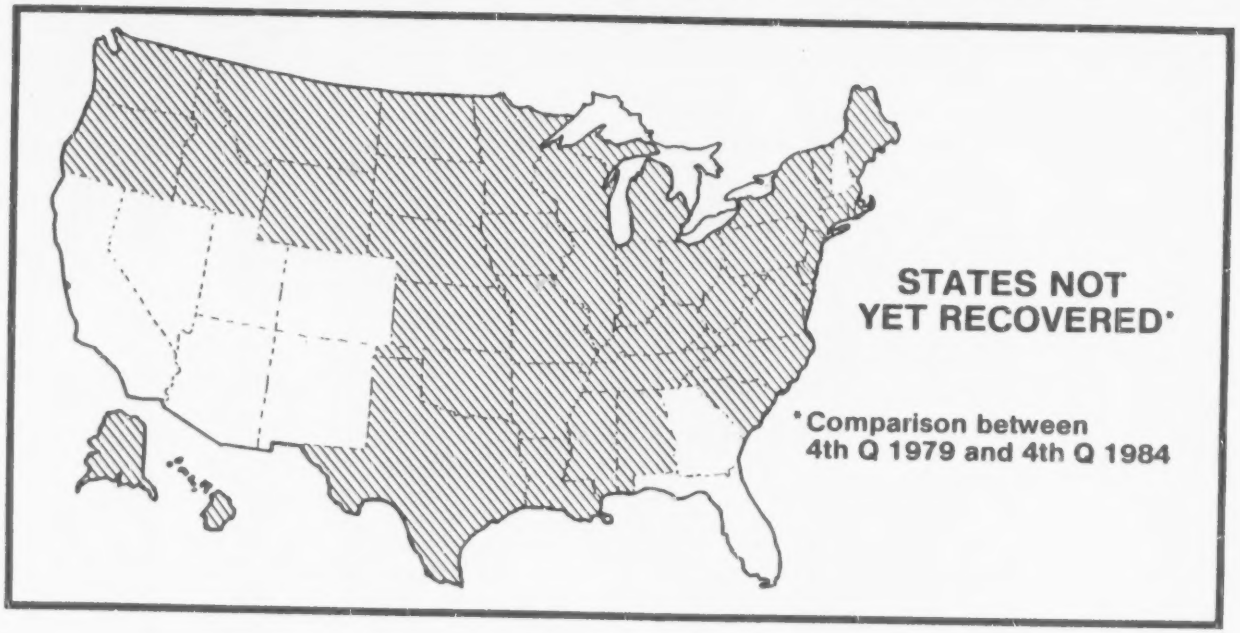


Exhibit 9

AFTER-TAX COST OF CAPITAL FOR MANUFACTURING

After-Tax Cost of Capital Index*	UNITED STATES		CANADA	FRANCE	WEST GERMANY	JAPAN	UNITED KINGDOM
	Current Law	Treasury II					
EQUIPMENT	57	73	59	68	71	67	66
PLANT	76	81	80	77	90	75	76

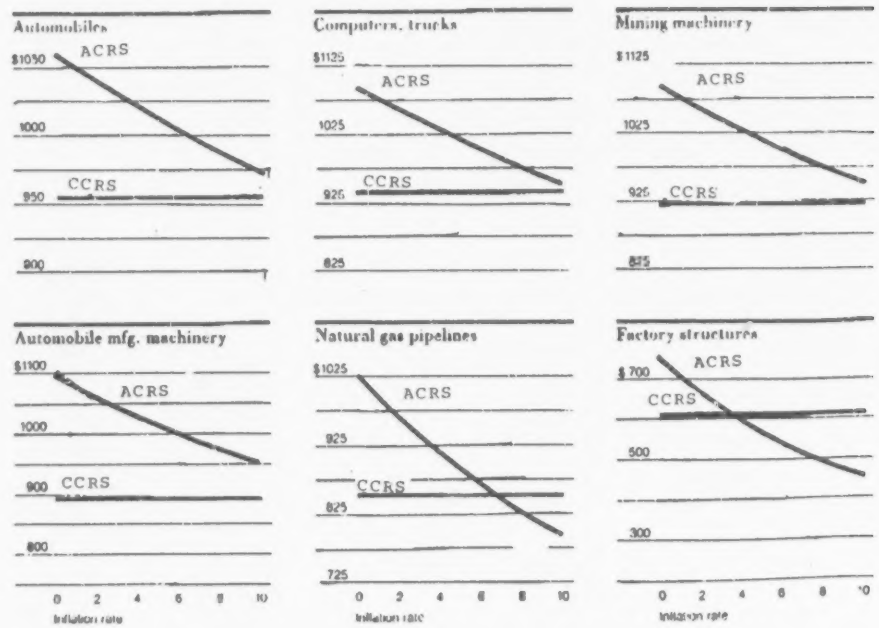
*Index is present value of after-tax cost of capital based on asset cost = 100 in local currency terms; assumes inflation = 5% and real discount rate = 4%.

Source: Arthur Andersen
GTE Corporation Tax Department

Exhibit 8

COMPARISON OF INVESTMENT ALLOWANCES

Present Value of Depreciation Plus the Deduction
Equivalent of the ITC Per Thousand Dollars of Investment



Note: Allowances are discounted at an interest rate equal to inflation plus a real interest rate of 4%.

Source: Morgan Guaranty Trust Company

STATEMENT OF JOHN H. MAKIN, PH.D., DIRECTOR OF FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. MAKIN. Thank you, Mr. Chairman. In general, I share the view of many economists that tax policy is an inappropriate way to encourage international competitiveness. Currently, I agree with the other witnesses that our major problem in this area lies with budget policy, which is the source of high real interest rates and the strong dollar. Turning to the impact of the President's tax plan on international competitiveness, let me focus on the question of whether removing ITC and changing from the ACRS to CCRS depreciaton systems would negatively affect U.S. international competitiveness in world markets. I would like to focus on three areas.

First, a suggestion from economic theory that I think has been overlooked in the past few years. If American exports are produced with capital intensive methods, as typically they are, tax measures to stimulate investment will increase their output relative to the output of labor intensive goods; and other things equal, the result will be a deterioration in the American terms of trade. If ITC and ACRS revenue losses are made up by increased taxes on other sectors of the economy, the result of a subsidy to capital acquisition as a transer from those at home whose taxes rise to the rest of the world, which experiences an improvement in its terms of trade. Let me put this another way. I think if we have learned anything from the experience since 1981, it is th at if you are going to give tax breaks for capital formation, like ACRS and ITC, you have got to make up the revenue somewhere else. If you don't you have bit deficits, a high real interest rate, and a strong dollar. That makes the investment that you encouraged not very productive. The whole problem we are facing now is the fact that we encouraged capital formation with policies that were aimed in that direction, but we forgot to make up the revenue. And so, we have a very strong dollar. We can either continue to have a strong dollar, or we can have a lot of inflation, but this is a very basic point here. If someone is saying don't take away this and don't take away that, then they have to say how you are going to make up the revenue. And that hasn't been done.

Second, the evidence since 1981 isn't encouragng regarding the ability of investment incentives to overcome exchange rates effects on international competitiveness. During 1983, export sales fell at 5.5 percent, while in 1984 they grew at only 4.7 percent, which is well below the overall growth rate of 6.8 percent. Meanwhile, imports rose by 27 percent. Studies have shown that ACRS and ITC investment incentives attracted just enough foreign investment to balance the revenue losses from the tax cut, leaving a net welfare effect of zero. I think there are three primary ways in which Tax Code could enhance U.S. international competitiveness, but they are really passive, in part and parcel of a well-designed tax system. The first would be to enact a code in which the level and distribution of tax burdens is not capriciously altered by changes in the level of inflation. Here, I am talking about the indexing provisions. The President's plan includes indexing provisions for depreciation, inventories, and eventually capital gains. This means that tax bur-

dens are largely insulated from changes in the level of inflation. The second positive way to go would be to equalize tax burdens across alternative forms of investment so that unsubsidized productive investment is encouraged at the expense of less productive subsidized investment. This is a point that this committee has heard many times; or that the investment mix is as important as the level of investment. As a matter of fact, the President's plan produces a modest increase in the overall tax rate on capital formation, but a major leveling of investment incentives across industry. The third would be to change tax treatment of interest income and expense to remove the existing subsidy for borrowers and tax on lenders. The President's tax plan accomplishes the first two of these objectives, that is the indexing and leveling, while leaving the third, the interest indexing, unrealized. Given the overall positive effects of the President's plan, which I have detailed in previous testimony before this committee, I believe that its small effect on international competitiveness does not reduce its overall appeal. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared written statement of Dr. Makin follows:]

DOES THE PRESIDENT'S TAX PLAN DIMINISH UNITED STATES INTERNATIONAL COMPETITIVENESS?

Testimony before the
Senate Finance Committee
Congress of the United States

John H. Makin
Director of Fiscal Policy Studies
American Enterprise Institute

July 18, 1985

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July 18, 1985 at 10:00 a.m.

DOES THE PRESIDENT'S TAX PLAN DIMINISH UNITED STATES INTERNATIONAL COMPETITIVENESS?

Summary

Mr. Chairman, I am pleased to appear before this distinguished committee to debate the impact of the president's tax plan on United States international competitiveness.

I share the view of many economists that tax policy is an inappropriate way to encourage international competitiveness. Currently, our major problem in this area lies with budget policy which is the source of high real interest rates and a strong dollar.

Turning to the impact of the president's tax plan on international competitiveness, I would like to focus on the question of whether removing the investment tax credit and changing from ACRS to CCRS depreciation systems would negatively effect U.S. international competitiveness in world markets. Three points should be considered.

1. If American exports are produced with capital-intensive methods, tax measures to stimulate investment will increase their output relative to the output of labor-intensive goods and other things equal, the result will be a deterioration in the American terms of trade and a negative impact on real income. If ITC and ACRS revenue losses are made up by increased taxes on other sectors of the economy, the result of a subsidy to capital acquisition is a transfer from those at home whose taxes rise to the rest of the world which experiences an improvement in its terms of trade. This is hardly what we want from tax policy.

2. The evidence since 1981 is not encouraging regarding the ability of investment incentives to overcome exchange rate effects on international competitiveness. During 1983, export sales fell 5.5 percent. Even as the economic recovery spread during 1984, exports grew at only 4.7 percent, well below the overall growth rate of 6.8 percent. Meanwhile, imports rose 27 percent during 1984.

Studies have shown that ACRS/ITC investment incentives attracted just enough foreign investment to balance the revenue losses from the tax cut, leaving a net welfare effect of zero.

3. There are three primary ways in which the tax code could enhance U.S. international competitiveness. The first would be to enact a code in which the level and distribution of tax burdens is not capriciously altered by changes in the level of inflation. The second would be to

equalize tax burdens across alternative forms of investment so that unsubsidized productive investment is encouraged at the expense of less productive, subsidized investment. The third would be to change tax treatment of interest income and expense to remove the existing subsidy for borrowers and tax on lenders.

The president's tax plan accomplishes the first two of these objectives while leaving the third unrealized. Given the overall positive effects of the president's plan, which I have detailed in previous testimony before this committee, its small effect on international competitiveness does not reduce its overall appeal.

Introduction

The primary features of the president's tax plan, with a direct bearing on investment, are elimination of the investment tax credit and a change from the accelerated cost recovery system (ACRS) to a capital cost recovery system (CCRS). There is widespread agreement that these changes will increase the user cost of capital for the category of investment known as equipment. Offsets, however, in the form of a 33 percent corporate tax rate, dividend deductibility, indexed depreciation, 50 percent exclusion of capital gains from taxation, and continued full deductibility of interest expense will lower user cost for structures, inventory, and land and leave user cost for public utilities largely unaffected.

Today's debate centers on the question of whether rescission of investment incentives like ITC and ACRS harms the ability of American producers to compete with foreign producers in the world marketplace.

At the outset, I want to make clear that in my view the major aspect of fiscal policy operative regarding the international competitiveness of American firms is budget policy. Budget deficits since 1981 have resulted in the most rapid peacetime accumulation of

debt relative to GNP in American history that has negatively impacted investment.[1] At the same time we have seen the highest real interest rates in American history. The result has been a surge in foreign portfolio investment in the United States that, at least through the first half of 1985, has resulted in a much stronger dollar. A stronger dollar has sharply reduced the competitiveness of American traded goods industries.

Today I'd like to explore three questions bearing on the relationship between tax policy and international competitiveness. First, what does basic economic theory have to say about this question? Second, does evidence accumulated since enactment of ERTA-TEFRA in 1981-1982 contain any lessons for the relationship between tax policy and international competitiveness? Third, what aspects of tax policy are most relevant for international competitiveness and based on these criteria, how does the president's plan measure up?

Economic Theory: Tax Policy and International Competitiveness

Consider the following question. If the United States enacts tax measures that increase the desired stock of equipment capital, will the competitive position of American firms be enhanced? The answer to this question depends on how the subsidy is financed, implications for the exchange rate, and the existing input mix of American traded goods. If American exports are produced with capital-intensive methods, a larger stock of capital will increase their output relative to the output of labor-intensive goods and other things equal, the result will be a deterioration in the American terms of trade and a negative impact on real income. That is, the price of what we sell in world markets will fall relative to the price of what we buy since the subsidy to export

industries will have increased the abundance of American goods in world markets. In a balanced budget setting, if the reduced tax burden on capital acquisition (ITC and ACRS revenue losses) is made up by increased taxes on other sectors of the economy, the result of a subsidy to capital acquisition is a transfer from those at home whose taxes rise to the rest of the world which experiences an improvement in its terms of trade. This is hardly what we want from tax policy.

Government subsidies to enhance international competitiveness are the object of harsh criticism by those who argue that Japanese government institutions "target" certain industries and sell goods below cost in the world marketplace, thereby driving legitimate producers out of production. This claim, like the claim that tax benefits enhance international competitiveness, suggests that taxpayers in the countries trying to enhance competitiveness will subsidize consumers in the rest of the world. Like most arguments for a subsidy, these arguments fail to pass the test that they raise the welfare of one group without lowering the welfare of another.

If, as in the case of the U.S. experience after 1981, the revenue loss from granting ACRS and ITC provisions is not made up by raising taxes on other sectors of the economy, the result is a sharp increase in deficits and debt accumulation that requires higher real interest rates which harm investment in two ways. First, the higher real interest rates offset the negative effect on user cost of tax incentives, thereby undoing the initial objective of the incentives. Second, the high real interest rates attract foreign portfolio capital inflows which strengthen the currency, which in turn sharply reduces the international

competitiveness of traded goods in the country experiencing rapid debt accumulation.

Economic Evidence Since 1981

The experience with investment and capital formation in the United States after enactment of ACRS and ITC incentives in 1981 is instructive. As already noted, such measures produce a finite increase in the capital stock that firms wish to have on hand. To satisfy that desire for a larger capital stock, firms temporarily accelerate net investment. Studies of the investment response to similar measures enacted by the Kennedy administration in 1962 suggest that the response occurs with a lag. This experience was repeated in the 1980s. During the latter half of 1983, growth of net investment accelerated sharply reaching a 30 percent annual rate in the fourth quarter of 1983. Thereafter growth of net investment has steadily slowed, exactly as would have been predicted given the temporary incentive effects on investment from measures that lower user cost. By the first quarter of 1985, nonresidential fixed investment growth was running at an annual rate of minus 1.6 percent.

Presumably, if the investment incentive measures had on net enhanced international competitiveness of American firms, growth of export sales would also have accelerated after 1982. The results here are not encouraging. During 1983 export sales fell 5.5 percent. Even as the economic recovery spread during 1984, they grew at only 4.7 percent, well below the overall growth rate of 6.8 percent. The picture for import-competing industries is far bleaker -- the rate for imports in 1984 was 27 percent. The reason is simply that exchange rate effects

more than swamped the effects of tax measures on the international competiveness of U.S. industry.

A closer look at the 1983-84 investment surge is even more damaging to the case for favorable effects on tax incentives on international competitiveness. Much of the investment boom was concentrated in the area of office equipment and automobiles. This is not surprising in view of the uneven effect of ITC and ACRS measures which effectively subsidize equipment acquisitions. Remember too that ITC and ACRS measures are available to American firms acquiring foreign produced equipment. Foreign sourcing is widespread for automobiles and office equipment.

It has been suggested that the increase in net direct investment inflows into the United States is related to tax incentive measures. Other have argued that the increase in portfolio and direct investment in the United States is due to deterioration after 1981 of investment opportunities elsewhere, particularly among the less developed countries. Which of these arguments is correct? The "less attractiveness elsewhere" view suggests that both foreigners and domestic investors should increase investment in the United States. This has occurred since 1981.

The welfare effects of a reduction in taxes on capital acquisition are difficult to calculate and not directly related to whether foreign investment responds positively to U.S. tax incentives like ACRS or ITC. It is necessary to balance possible enhanced capital inflows against the revenue loss (which must be made up from other sources).

The case where foreign investment is unresponsive to lower taxes on capital acquisition is a definite loser since revenue losses are not

offset. Suppose a foreign firm were to invest in the U.S. and because of ITC/ACRS incurred no tax liability. If that firm repatriated U.S. earnings, it would get no U.S. tax credit and would have to pay domestic taxes just as if it had invested at home. In this case U.S. tax policy favorable to capital acquisition produces no incentive for a capital inflow and the result is just a revenue loss.

In a more favorable case the foreign firm investing in the United States may enjoy a lower tax liability due to ACRS/ITC and not repatriate earnings but rather reinvest profits. This strategy works as long as the after-tax return in the United States exceeds that in the home country. In other words the American ACRS/ITC provisions ought to raise foreign investment if the resulting drop in effective tax rates increases the after-tax return in the United States above the after-tax level abroad.

Investigating the responsiveness of foreign investment to lower taxes on capital in the United States, Hartman (1984) finds that increases in foreign investment just balance the revenue loss from the tax cut.[2] In short, the net welfare effect is zero.

Even if one grants that foreign investment responds positively to lower U.S. taxes on capital and even if this response exceeded the revenue loss (which it does not), it is still not clear that the Preident's proposal hurts foreign (or domestic) investment incentives. Fullerton (1985) finds that the president's plan reduces the tax on capital acquisition for structures, inventories and land while raising it for equipment and leaving unchanged the tax burden on public utilities.[3] Therefore, the effect on foreign investment depends on its

mix. If it is equipment-intensive, the effect will be negative. Otherwise, the effect will be positive.

How Can Tax Policy Help International Competitiveness?

There are three primary ways in which the tax code could enhance U.S. international competitiveness. The first would be to enact a code in which the level and distribution of tax burdens is not capriciously altered by changes in the level of inflation. The second would be to equalize tax burdens across alternative forms of investment so that unsubsidized productive investment is encouraged at the expense of less productive, subsidized investment. The third would be to change tax treatment of interest income and expense in a way that does not subisidize borrowers while taxing lenders.

One of the main arguments for enacting ACRS and ITC measures was to effect an ad hoc correction for the increase in the corporate tax burden that arises from inflation. Unindexed depreciation and inventory allowances and unindexed capital gains all contribute to an effective increase in taxes on capital. The rapid acceleration of inflation during the 1970s was no exception. ACRS and ITC were ad hoc measures to correct for what amounted to corporate bracket creep during the 1970s.

A better way to deal with corporate bracket creep is to index depreciation allowances, inventory evaluation allowances, and capital gains. The president's proposal does this; consequently, effective tax rates on capital are far more predictable over the life of a typical investment project. The result is a reduced need for ad hoc adjustments in the tax code and more stable prospective tax burdens that encourage investment. Fourteen separate enactments, modifications, and

rescissions of investment incentives in the U.S. tax code since 1962 cannot have helped to produce a stable environment for investment.

The president's tax plan also enhances international competitiveness by stabilizing tax rates on new investments across alternative forms of capital. As already noted, the president's proposal lowers the marginal effective total tax rate on structures, inventories, and land while raising the rate on equipment acquisition. As many other witnesses before this committee, including myself, have emphasized, unsubsidized capital investment is more productive and therefore more conducive to international competitiveness than subsidized investment. With regard to investment, that its overall level and its composition are important. The president's tax plan increases by 10 percent the marginal effective total tax rate on capital for corporations while reducing the standard deviation across different categories by nearly 50 percent. This reduction in the unevenness of tax burdens, together with the increased prospective stability of the tax code given indexing provisions, will on net enhance growth of investment and productivity. Tax policy directed at increasing one form of investment at the expense of others is the equivalent of trying to get more power out of an engine by forcing more fuel and no more air into the combustion chambers. The mix between air and fuel is just as important as the total amount of the mix forced into the engine. Too much of one or the other creates a rough-running, inefficient engine that frequently stalls.

The tax treatment of interest income and expense is an important area in which tax policy can affect international competitiveness. In this regard the U.S. tax code is severely deficient. Full deductibility of interest expense including all household interest expense constitutes

a heavy subsidy to borrowing and consumption, while full taxation of interest income creates a serious saving disincentive. A borrowing subsidy coupled with a tax on lenders results in market interest rates in the United States that must be artificially high in order to maintain after-tax real rates demanded by borrowers and lenders. The result is that U.S. market interest rates appear even higher in after-tax real terms to foreign investors where tax policy on interest earnings differs. American market interest rates are therefore high enough to strengthen the dollar even more than it would be strengthened in the absence of our distorted treatment of interest income and expense.

The Treasury's November 1984 tax proposal, by indexing interest income and expense, would have resulted in a reduction in interest rates by two to three percentage points. This conclusion is based on extensive research which I conducted for the International Monetary Fund and summarized briefly in an article for the Wall Street Journal which is attached to my testimony.

In sum, the president's tax plan contains indexing provisions sufficient to preclude the need to reintroduce ad hoc corrections such as ACRS and ITC and thereby reduces uncertainty about the prospective level and distribution of tax burdens. It also evens out the tax treatment across different categories of investment. Given these two positive aspects, even though the president's plan forgoes the opportunity implicit in the indexation of interest income and expense, in my view it does not diminish U.S. international competitiveness; rather, it mildly enhances it. Given the overall positive effects of the president's plan, its small effect on international competitiveness does not reduce its overall appeal.

Notes

1. John H. Makin and Raymond D. Sauer, "The Impact of Debt Accumulation on Capital Formation." Studies in Fiscal Policy Working Paper No. 1 (Washington, D.C.: American Enterprise Institute, Nov. 1984).

2. David G. Hartman, "Tax Policy and Foreign Direct Investment in the United States," National Tax Journal (December 1984), 475-88.

3. Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains: A Model of Investment Incentives." Studies in Fiscal Policy Working Paper No. 5 (Washington, D.C.: American Enterprise Institute, June 1985).

Wall Street Journal Jan. 7, 1985

Treasury Plan Could Cut Rates by Two Points

JOHN H. MAKIN

The Treasury's tax-reform proposal may not be designed to raise revenue, but it could lower deficits. By indexing the inflation-induced portion of interest income and expense, it simultaneously reduces a subsidy to borrowers and a tax on lenders. Both effects would lower interest rates and thereby reduce the interest bill on the federal debt.

How much help could we expect? Depending on the degree of indexing (the Treasury plan currently amounts to partial indexing) and the pervasiveness of indexing (interest expenses on a principal residence are currently left unindexed), the possible drop in interest rates ranges from about one to three percentage points. Based on estimates by the Congressional Budget Office, every percentage-point drop in interest rates lowers 1985-90 deficits by about $75 billion, largely as a result of financing at lower interest rates more and more of the federal government's $1.7 trillion-and-rising debt.

It helps to remember, when thinking about inflation indexing of interest income and expense, that borrowers and lenders are interested in after-tax real interest rates, that is, interest rates after adjustment for inflation and taxes. No sensible lender will agree to a 6% interest rate if he believes that inflation will be 6%. At 6% interest a lender's $1,000 loan returns $1,060 after one year. But 6% inflation means that it takes $1,060 to buy what $1,000 would have bought at pre-inflation prices. Also, under current law the $60 in interest would be taxed. A lender in the 33% bracket would be left with $1,040 after tax.

Naturally, borrowers would be very happy under such conditions. But as lenders discern the need to set interest rates at levels consistent with positive real after-tax returns, nominal rates rise and the rise is accentuated by taxation of the inflation portion of market rates. Return to the example above and suppose lenders and borrowers agree on an after-tax real rate of 3%, while both expect 6% inflation and are in a 33% tax bracket. They will agree on a 13.5% nominal interest rate since 13.5% less the one-third tax bite yields a 9% after-tax return (3% minus inflation).

The Treasury's tax-reform plan proposes eliminating the inflation factor by taxing or deducting only the real portion of interest income or expense. It also lowers average effective marginal tax rates by 20%, so that we may suppose that the average effective marginal tax rate falls to 26% from 33%. Both of these changes mean that market rates can fall while leaving after-tax rates unaffected.

There are sound reasons for the drop in rates. Under the current system lenders know that if inflation rises and pushes up interest rates they will be taxed on the illusory gains from a rise in nominal interest rates that only compensates for higher inflation. Lenders therefore demand higher nominal rates than they would if inflation-induced rises in interest rates weren't taxed. Borrowers, knowing that they can deduct from tax any illusory inflation-induced interest costs, are willing to pay the higher rates.

The result is a multiplication of upward pressure on nominal interest rates from higher expected inflation.

The effect of exempting all but real interest from inclusion in interest income and expense is to reduce the nominal interest rate that yields an after-tax real rate of 3%. With 6% expected inflation and a 26% marginal tax rate, a 10.05% nominal rate yields an after-tax real rate of 3%. Since the inflation part of interest income isn't taxed or deducted, 10.05 minus 6 gives a taxable/deductible interest rate of 4.05%. Twenty-six percent of 4.05 is the 1.05% that lenders pay as tax or borrowers save in taxes, leaving a 3% after-tax real rate.

The drop from 13.5% to about 10% that results from taxing or deducting only the real portion of interest income or expense is greater than the drop that would result from the Treasury plan. By setting the untaxed or nondeductible portion of rates at levels above 6% rather than 3%, the Treasury proposal amounts to partial inflation indexing of interest income and expense. In the 10.05% example, 11.1% would be required to yield a 3% after-tax real rate under the Treasury plan. Furthermore, the Treasury plan still allows households full interest deductibility on the sum of mortgage interest on principal residences, $5,000 and net investment income. This special subsidy to household borrowing for home ownership and purchase of consumer durables would raise rates.

Even with partial indexing and exceptions for households, the Treasury plan would result in a drop in rates by 1.5 to 2 percentage points. The resulting drop in 1985-89 deficits by $112 billion to $150 billion, coupled with about $240 billion in 1986-88 spending cuts attributed to administration budget-axers, would erase more than $350 billion—more than 35%—from the $1 trillion or so of red ink that will gush out of Washington under current tax and spending plans. Such a saving would prevent the rise in national debt relative to gross national product that now threatens to crowd out private investment over the remainder of the decade.

We are a nation of heavy borrowers, thanks partly to encouragement by our tax system and partly to the government's decision to spend far in excess of tax revenues. By allowing deduction only of real interest cost and taxing only real interest income, the Treasury plan reduces the tax incentive to borrow and the tax penalty on lending and thereby helps to produce a drop in interest rates that will reduce deficits. By aligning U.S. tax treatment of interest income and expense more closely with tax policy in most other countries, the plan would have the desirable side effect of reducing a current tax-code-induced contribution to an overly strong dollar. A lower dollar and lower interest rates are necessary if we are going to employ profitably all that new machinery built during the post-1982 U.S. investment boom.

Mr. Makin directs fiscal-policy studies at the American Enterprise Institute.

The CHAIRMAN. In this committee, we follow the first come, first served rule on questions. Dr. Makin, let me ask you this. As I read your testimony, first I could see that you are saying that the investment incentives in 1981 were not sufficient to overcome the adverse exchange rates, if I understand what you are concluding. What I couldn't tell is whether you thought the 1981 investment incentives really work, anyway—forget the international exchange rates—or whether all you dod is get a quick accleration followed by a greater slowdown that you would otherwise get if you hadn't had them at all.

Dr. MAKIN. Let me talk to that point, Senator. The 1981 measures were an effective way to reduce the user cost of capital, and traditionally what happens when you do that is you create a desire for companies to buy more machines. And they go out and buy the machines, and then they finish. So, you have a temporary increase in net investment, and it usually peaks about 2½ years after enactment. And I think that is what we have had. I think the trouble is that we tricked those who invested. When they bought the capital, they weren't planning on a dollar that is where it is now. Then, the problem goes back to having enacted measures without having gotten the revenue somewhere else. So, what I am saying is that they have a temporary stimulative effect that is now gone, by the way, looking a the numbers; and if you take into account the fact that you really ought to be raising taxes somewhere else when you put these measures into effect, their net causitive effect is not very great.

The CHAIRMAN. So, in balance, you would just prefer to use a normal depreciation system with useful life definition and let it go at that in terms of investment incentives?

Dr. MAKIN. On balance, I rather like the combination that is in the President's plan. The main important thing, I think, are the indexing provisions.

The CHAIRMAN. You mean his new depreciation schedule? When you say the main thing——

Dr. MAKIN. The CCRS schedule is indexed and, therefore, when a corporation is looking out over the future life of a project, under current law they have to say that if inflation is 8 percent, we have one rate of return; if it is 4 percent, we have another. If you try to index measures such as those affecting depreciation and inventories, that is one element of uncertainty that is removed.

The CHAIRMAN. And with that it would be sufficient? I am coming back again to whether or not this committee should be at all concerned with investment tax credits, with additional aids to stimulus beyond a rational—and you would say indexing is rational—depreciation program?

Dr. MAKIN. I think that here, again, there is a balance to strike. There are two dimensions that one has to worry about with investment. One is the mix, and current law, I think, is much too heavily weighted toward one form of investment—the equipment category. And the other is the overall level. Here, again, I think the best guide we have is probably international comparisons. When one looks at international comparisons under the President's proposal, one finds that the U.S. burden on capital formation would fall

about in the middle. It would be comparable with that, say, in Japan, where capital formation certainly isn't a big problem.

The CHAIRMAN. Dr. Mauer, do you think that the Tax Code probably tilts too heavily toward consumption?

Dr. MAUER. I feel that the Tax Code as it was prior to the enactment of ITC and ACRS—the 1981 changes—had such a bias, and I feel that that bias was to a considerable extent offset by the adoption of that 1981 legislation. So, I guess in terms of evaluating the President's proposal, to the extent that that proposal would made those capital recovery provisions less attractive, that that would be less desirable.

The CHAIRMAN. And how do you feel about moving toward a business transfer tax somewhat similar to what Senator Roth has suggested, or some other form of consumption tax or excise tax—call it what you want?

Dr. MAUER. Let me come back to your earlier point, which I think reall deserves quite a bit of attention. We use capital in this country in different ways, not only in the business sector but also in the household sector. And one of the great consumers of capital is the residential housing industry which is heavily biased towards the consumption side. I feel that, in terms of social policy in the United States, this is a practice which we wish to continue; but we should know the implications of continuing that allocation of capital throughout the economy. And the key implication is that this quite large subsidy in our present Tax Code toward residential construction in the form of interest deductibility on such investment. This have a quite sizable bias. Now, much of our discussion this morning will be about efficiency within business investment asset classes, but I am raising the point that, if we wish to talk about capital formation more broadly in the economy, we should also recognize that there is this other source of inefficiency in the economy; and this distortion comes to be offset by the legislation that was adopted in 1981. In that sense, a bias toward consumption and against savings and investment prior to 1981 to a considerable extent improved with the 1981 legislation. Now, there are discussions to reduce those incentives.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. I, too, appreciate the makeup of this panel today because I think the problem we are addressing is probably the most important one in considering tax reform. Before I get into some of my more specific questions, I did want to ask Mr. Pratt one question. Regarding your testimony, it is in a sense contrary to what I have been hearing from a number of business people. If I understood your opening remarks, You think that the introduction of a major tax reform in one fell swoop is perhaps too much for the system, and it would be better if we moved at a slower pace? Many business people have complained to me that it is the uncertainty that is creating great problems. They would like us to move and then freeze, so they know what the rules of the game are. Some of them say that we think we are smart enough to live with whatever it is, but they are very much concerned that we have had a new tax package every year and we revise it and change it. So, it is very hard to make an intelligent decision. So, it is interesting to hear that you take somewhat of an

opposite point of view. Does it concern you that if we phased in these changes over a period of several years—are you suggesting that we legislate every few years? Or are you suggesting that we have a major package but phase it in over a period of years? Or what would your recommendations be in that regard?

Mr. PRATT. Obviously, Senator, it is a complicated issue, and I should say that at the beginning I said I was speaking for myself and our company as well as for ECAT. On the particular matter that you have raised, it would be unfair to sasy that I am speaking for ECAT. On the issues relative to the impact on foreign competitiveness that I really zeroed in on, those represent the views largely of ECAT as well as ourselves. You are quite right that the views of businessmen in general are all over the lot on the desirability of the tax action per se. I would describe my view of what most businessmen are saying as: "We feel that the idea of tax reform is a great idea. How can you be against lower taxes and a simpler tax system? They start out saying yes, this is a great idea, *but*," and then they knock off all the issues that are in the plan. [Laughter.] And I find that intellectually a little difficult to face. I think they are really saying about the sae thing I am saying, only they say it a different way. I find that more and more businessmen who started out saying "this is a great idea," now that they have gotten indepth into the impact of the problems caused by the vast number of changes, are beginning to have second thoughts. But you are quite right. I would say the majority of businessmen, even now, probably start out saying "I think it is a good idea but." I suspect if you examine the "buts" you will find that we are not too far apart. I would say it has a lot to do with your feeling about what the future is going to be. I think no matter what we do, we will always have continued tax reform. I don't think you are ever going to be able to pass a once-and-forever tax bill and solve all the problems. You are absolutely right. If you could do that—if we could have set of tax rules that we agree on and have no changes—we would have certainty rather than instability which is the greatest problem to any businessman. And rules that you know are going to last for a long time are absolutely most desirable. I just don't have any confidnece that, in our rapidly changing society, we are every going to reach a time when Congress is going to find that there are not new conditions arising that are going to cause future changes, or the need for changes. I think the things in our Tax Code that need to be changed and are called unfair are items that were put in for a good reason, and most of them are probably still desirable. And then, we try to throw out the whole package at one time. I am sure we will make a lot of mistakes in trying to throw the whole pacakge out at once. It has already been modified a tremendous amount, of course, since it started off. I would be more inclined for us to tackle the areas that clearly need reform which we have all the time. But as I said at the beginning, I would rather see us working on the deficit right now; and perhaps the need for overall tax changes in amount rather than upsetting the whole system and diverting our attention from the budget deficit. I think in the long run we are going to end up not making anything like the size change that we started out thinking, anyway, and we will have wasted a lot of time.

Senator ROTH. Let me comment that I think in whatever reform has come about, the most important goal is to create an environment of growth in future years. Frankly, I think too little emphasis is made of that particular purpose. I guess my time is up, Mr. Chairman. So, rather than proceed with this line of questioning at this time, I will wait until my next round.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Before I proceed, I am wondering if, in addition to the testimony that these witnesses are giving, whether our committee could make a formal request of the ITC for a section 332 study of the impact of the President's proposal on U.S. competitiveness?

The CHAIRMAN. I received your letter on that yesterday; and as soon as we have a markup or a full committee here, I will put that to them. As you know, the full committee has to vote on those requests. And I will talk with the ITC about it, too. That is a reasonably major request.

Senator BAUCUS. I understand they can handle it. My staff has checked on that.

The CHAIRMAN. This isn't just a one-issue study. This is a rather broad-based study. Let me give them a call first before the committee meets and ask them if they can do it.

Senator BAUCUS. Thank you. Mr. Pratt, one obivious question comes to most people's minds when you talk about the need to keep a global system rather than a country-by-country limit for the foreign tax credit. The question that arises in the minds of some people is: Isn't that just exporting jobs overseas? What is your answer to that?

Mr. PRATT. I think the numbers are pretty clear on this. We have been studying this for the last 15 years, every year. The best data we can put together of the impact on foreign investment shows staggering numbers. And I mentioned a few of those numbers in my testimony. The latest data we have is 1980, but it is similar to past years, and I am sure it represents the future as well. 40 percent of all of our exports go to foreign-owned subsidiaries of American companies, and 80 percent of all manufactured exports are made by multinational companies, that is, companies that do invest abroad. Further, the data suggest that those companies that have a signficant investment abroad have their U.S. employment growing faster than companies that do not. Those data say to me very clearly that one of the best things you can do to stimulate U.S. jobs is to help stimulate foreign investment and foreign competiveness. It is, after all, a world market. We go abroad not for tax savings; we go abroad because that is the way you get the market.

Senator BAUCUS. What do other countries in this area? Do other countries have a global system, or do they have a country-by-country system?

Mr. PRATT. No; my information, from the studies that have been reported to me, is that they either have a purely global system or a system that results in that kind of effect. So, we would be almost alone among major nations in going to a per-country basis of consumption if we did go to that. You know, like all these things, you could hardly say that it would put us all out of business next week, but it is another relative negative and we just don't need those.

That is the way I would put it. It gives the other guys an advantage relative to investing abroad, which I start out saying is one of the most important things this country should try to stimulate.

Senator BAUCUS. I believe one of Treasury's premises in moving to a country-by-country system is the assumption that other countries have a country-by-country system.

Mr. PRATT. I believe they are mistaken.

Senator BAUCUS. Really?

Mr. PRATT. I believe they are mistaken.

Senator BAUCUS. Basically, you are saying that most of other countries, if not all, have a global system?

Mr. PRATT. They either have a global or the equivalent of a global system.

Senator BAUCUS. Thank you. We talk about neutrality or, in others' words, moving away from the bias toward heavy equipment and smokestack industries, that is changing the bias in the Code which encourages investment in those industries toward a system which eliminates ITC and reduces the ACRS, but, lowers overall corporate rates. There seems to be an assumption in the discussion that there will be the same total overall aggregate investment. The question in my mind is: Given way this bill moves in an attempt to discourage some of the incentives and some of the biases toward certain industries and equipment, what assurance is there that we have the same aggregate investment in this country? I wonder if perhaps corporate managers are going to possibly use their lower corporate rates to do something else? Could you address the assumption that there will be the same—or more—investment?

Mr. PRATT. Yes; I have a comment on that. I am not an economist, and I am surrounded by some economists; and there are different ways of looking at things. My view is precisely what you have said. We have stimulated investment in industries where, for various reasons, it was difficult to get the investment that it was thought we needed; and that is why incentives were given to certain industries. I think you are absolutely right. I suspect in a theoretical world, over the long, long, long pull, maybe it would all even out; but we are all dead by that time. I think, in general, that the need to stimulate investments in desirable industries is a valid need and should be continued; and in my judgment, within a reasonable period of time, you would not get an offsetting result by the natural workings of the economy, as theoretically is claimed.

Mr. LANGDON. I guess my view on that is that the Tax Code should be more neutral with regard to promoting certain industries over others. We are in a high rate of change, both domestically and internationally, with regard to the markets. It is my view that the businessman is the best person prepared to make the adjustments to meet those market changes, and we should encourage the businessman to make those kinds of changes. Within our firm, we frankly do not give general managers a scorecard on the basis of after-tax effect of their decisions. We do it on a pretax basis because it just complicates their lives too much, and we have been reasonably successful.

Senator BAUCUS. I wonder if I could ask one followup question, Mr. Chairman? Aren't we essentially talking about the difference between the short and the long term? Some observers of American

business and American society suggest that in our country we live too much in the short run while other countries and societies look a little bit more toward the longer term. Maybe we focus too much on the short term here, I wonder if corporate managers have so many short-term pressures that maybe it makes some sense to build in some longer term incentives, like the investment tax credit and an ACRS generally?

Dr. MAKIN. May I speak to that?

Senator BAUCUS. Surely.

Dr. MAKIN. I think the fact is that ITC and ACRS are short-term measures. Go back and ask what was one of the primary rationales for enacting those measures? It was that the high rates of inflation that we experienced in the late 1970's—and this is a point that many of the witnesses have emphasized—had in effect increased the tax for noncorporations. Because of the absence of indexing provisions on depreciation and on inventories, this is a point that Marty Feldstein has written books about and is a point that motivated the ACRS and ITC. So, when we are looking at the long run, we really ought to be saying to businesses, look, your tax burden is predictable under different rates of inflation. And that is what the indexing provisions do.

Senator BAUCUS. Marty Felstein sat right where you are sitting now about 2 weeks ago and said we should not repeal the investment tax credit.

Dr. MAKIN. I am aware of that.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Chairman, first let me say that this panel has presented such challenging testimony that I think it is difficult to justify having all four men testify at the same time because they are very excellent witnesses, in my judgment. I know your problem. I have the problem myself and I am trying to move on with the hearings. So I am going to ask the entire panel not to respond at the moment to the queston I am going to ask but, if they are so inclined, to expand on their testimony by giving me their answers to the same questions I am going to ask Mr. Pratt, for example. Now, Mr. Pratt, you are testifying here for Pfizer and you are also testifying for the ECAT.

You have explained that in some respects you are not speaking for ECAT, and I assume that is because you haven't had the opportunity to ask all the members just how they feel about certain matters. So, I am not going to ask you to speak for them except insofar as you think you should or that you are in a position to do; but I do think it would be helpful to us if we would know from you—and after you leave here, you might want to poll the members of ECAT—how they would respond to the questions I want to ask you here.

First, I want to ask you this: Is American industry generally opposed to certain foreign provisions proposed by the Treasury in this bill; and if so, what provisions? For example, does American industry oppose the elimination of the overall limit and the substitution of the per-country limit? Now, Pfizer can take its position, and you can answer for your ECAT associates as you see fit. Incidentally, it would be all right with me if you asked your friends at the Business

Roundtable what they think about this matter because those are all very significant individuals, they are prestigious people, and they work hard for their country as well as for their shareholders. What is your general view on that?

Mr. PRATT. I don't have any trouble at all answering that one, Senator, and speaking for ECAT in this case. All the members of ECAT, and there are 63 members who represent a major segment of American industry including many of the Business Roundtable members, would be strongly against that change. Most of these companies have a signficant presence abroad. It is an important part of their business. We all consider that to be a very dangerous move, not only from the point of view of financial impact and competitive impact upon us, but complexity. I think the more people look into this, both from the Government's point of view and our point of view, it would be madness to try to operate that kind of system. And that is why it was thrown out in the past. As you know, we used to have a per-country limitation; and the difficulties that it caused were so great that Congress first allowed you to have a choice and then ruled out the per-country and went completely to the overall. We see both from a complexity and a fairness and a competitiveness point of view that there is almost no American company that wouldn't feel strongly that that is a mistake.

Senator LONG. Again, let me say that I think it would be helpful to us, insofar as members of ECAT or members of the Business Roundtable or the business council feel like expressing themselves on this question, considering the respect that we hold for all of those groups, to know—insofar as each one of those groups had an opinion on it—what they thought. As a group, they have investments in all 50 States. Now, does American industry oppose the repeal of current allocation of the interest provision, which would source from the United States to foreign operations interest expense paid by the U.S. company operating only within the United States, thus reducng the foreign tax credit? Do you understand what I am talking about?

Mr. PRATT. Yes, but I think I will ask the gentleman to my right to speak to that. [Laughter.]

He seems to know.

Mr. LANGDON. Yes. In general, most U.S. companies, Senator, oppose that provision as well. And let me underscore what Mr. Pratt said on the earlier point as well. I don't think I know of a single American company—and that is in spite of the fact that we support the President's proposals generally and favorably—that supports those particular international provisions of the proposal. The dilemma our good friends at the Treasury had was having to deal with reducing the overall corporate rate from 46 to 33 percent and rationalizing that conceptually. Perhaps the solution on international income is to keep all of those provision in place and keep it at a 46 percent rate, if that represents parity. The other provision that Mr. Pratt mentioned—the complexity on the resourcing rules—is exceedingly complex. We are a computer company. We are going to sell a lot of computers because of that, but frankly, I don't think it is a good use of our product or resources in this country to force every multinational company into massaging their foreign source income in a particular country six different ways.

Senator LONG. Do you agree with that, Mr. Pratt?

Mr. PRATT. Yes, I do.

Senator LONG. All right. Now, the studies about what I think is our number one problem in the area of so-called tax reform is misconception. People out there have been led to believe that the rank and file of rich people are just not paying any income tax. That is badly in error. Furthermore, when the specific cases are picked out—and you have heard people say that here are five big companies that paid less taxes in a given year that some little widow with three children who is making $15,000 a year—it can be very much misleading. And one of the biggest items of misunderstanding has to do with the foreign tax credit, where a company has paid to a foreign government more n taxes than they would owe to this country; and under a rather traditional method of international treatment of overseas income, they are permitted a credit for that. Now, I want to know from you how you feel about having something in the nature of a minimum tax applied to that type of situation? That would be really for image purposes only, to eliminate the appearance of people paying nothing or paying less taxes than a widow with three children making $15,000.

Mr. PRATT. Yes, I have thoughts on that. The paying of higher taxes abroad, of course, would not cause them to pay no taxes here because they could only have the amount adjusted equal to the U.S. rate. But it is true that through foreign tax credits and other tax incentives, companies can be put in a position where in certain years they pay no tax. Philosophically, it would seem to me that that is probably a good thing. If you have created incentives to do things you want done and a company spends a lot of money to do it and pays no tax, it ought to get a pat on the back. You are right, though, that in today's world seeing that is considered to be a negative. And I have reluctantly come to the conclusion that probably we should have some provisions that prevent that from happening, just because of the political problems that it causes. So, I would think a minimum tax would be the best answer to that.

Senator LONG. Thank you very much.

The CHAIRMAN. I might say that we are going to have a hearing in September on just the foreign tax aspects of this bill, and we had asked the panel to reasonably limit themselves to the domestic tax aspects today. Senator Chafee.

Senator CHAFEE. Mr. Chairman, I apologize. I and several other members of this committee were at a National Parks hearing where I had to make a presentation. So, thus, I apologize for being late. I want to congratulate Mr. Pratt for all the work he has done in connection with the competitiveness of U.S. industry and the testimony he has given before this committee and other committees. I presume he gives some attention to Pfizer when he has a chance, but he certainly has devoted a tremendous amount of his precious time and energy to helping us up here on various matters.

Mr. PRATT. Thank you.

Senator CHAFEE. Mr. Pratt, there is one thing in your statement I would like to discuss. I just saw the summation of it here. It runs a little bit contrary to the advice we have been getting from various other witnesses, and that is that they say, for goodness sakes, leave the Code alone for a while. Every time this Congress meets,

they feel a compulsion to tinker with the Tax Code, so we don't know where we are going. Yet, it seems to me that that is exactly what you are suggesting when you talk, in your summation, about a slower-paced timetable. Isn't that going to keep industry on the edge of its seat, not knowing what is coming next? If we are going to do this, let's either do it and get it over with, or not do it and stop there?

Mr. PRATT. We discussed that briefly before you were here.

Senator CHAFEE. I am sorry to have to repeat a question that you have already discussed.

Mr. PRATT. I would just summarize quickly by saying tht I guess I am on both sides of that question. I just believe that the attempt to throw the whole Tax Code out the window in concept, after all these years, is more than we can handle effectively. So, I merely said that, in my opinion, we are biting off too much, and that our experience is sort of suggesting that that is the case. No, I am not really asking for having a tax reform bill every year. However, on the basis of experience, I assume we will have one, anyway. [Laughter.] So, whether I want it or not—[laughter]. I am really saying that I don't think the situation justifies this dramatic an action. I know I support our President strongly, and I have right from the beginning, but, on this issue, to build up the fact that the whole system is a mess and is completely ineffective, is untrue. And it doesn't justify the degree of effort that we are trying to put into it, nor do I believe it will be productive. So, I am saying that it is a complex society, and we can't have a very simple Tax Code in a very complex society, in my judgment. We will always be tinkering to some degree with it. It is better not to have that, but we can live with modest tinkering, I think, easier than a dramatic overhaul like this. It is a question of judgment.

Senator CHAFEE. Thank you. I am going to look over the testimony of everybody here, and particularly Mr. Langdon because you and Dr. Makin are a refreshing breeze here. We have not been overwhelmed with those in favor of the administration's proposal. They came the first day, and this is our 15th day of hearing after the first day, and it has been downhill ever since. [Laughter.]

Senator CHAFEE. So, you have at least held us even for one day here, gentlemen. I look forward to looking over your testimony.

The CHAIRMAN. You missed the testimony of that compny yesterday—TXO, the biggest independent gas driller in the country, and one of the biggest oil drillers, who supported the plan.

Senator CHAFEE. Well, he is notable. [Laughter.]

The CHAIRMAN. Dr. Makin, I have read your Wall Street Journal article and your testimony. I wonder if you would elaborate a little bit on how indexing interest is going to reduce our interest rates two to three points? It would clearly be a desirable advantage if it indeed works. Tell me why it works to reduce our interest rates.

Dr. MAKIN. I would be pleased to do that, Senator. First, it relates to the basic issue. How would I describe what we did in 1981? We put into effect heavy investment incentives with few saving incentives; and so, since then, we have been importing a lot of saving and we get a strong dollar. Why does the United States have one of the lowest rates of saving in the industrial world—in fact, a rate that is about one-third the Japanese rate? One of the reasons is

that we heavily subsidize consumption. Why do we have a heavily subsidized consumption? This is the only country in the world where households are able to deduct all interest expense, irrespective of the use to which it is put. So, if you have a system in which you can deduct all interest expense, even in an inflationary period where interest rates rise to reflect the inflation, you are essentially encouraging consumption as inflation picks up and thereby encouraging more inflation. So, in effect, by allowing full deductibility of interest expense for households as well as businesses, on top of other provisions, you are encouraging consumption. You are not encouraging households to put their money aside or put their money into financial instruments. You are encouraging them to go out and borrow as much as they can--buy a second car, buy a third house, whatever. This is wasteful. On the other side of the ledger, if you are fully taxing interest income, here again you are putting lenders at a disadvantage. So, what you have is a situation where you are taxing lenders and subsidizing borrowers. Now, the counter example I have in mind is the situation in other countries, and the most extreme case is Japan. Their tax treatment of interest income and expense for households is the reverse of ours. Interest expense is not deductible for housing or any other reason, and interest income is not taxable. So, what happens? You have lower interest rates and you have a sitution where, when the Japanese look at interest rates in the United States, which are artificially high because of our tax treatment of interest income and expense, it is even more attractive. So, they want to move funds into the United States, and we have an artificially strong dollar. So, I have advocated the idea of indexing interest income and expense as a way to take a subsidy away from borrowers and take a tax off lenders, that is to encourage saving, to discourage borrowing for consumption reasons. In effect, this would bring down interest rates, if they are currently in the 10 to 12 percent range, by about two percentage points because you are essentially taking away the encouragement that the tax system gives to borrowing.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. Does the lack of a border tax adjustment in the United States put us at a competitive disadvantage in terms of our major trading nations? Does the fact that they can rebate tax on exports and taxed imports hurt us? I wonder if each of you gentlemen would comment on that. Dr. Mauer?

Dr. MAUER. Senator, I myself am in full agreement with the way that you have put it; and as a matter of fact, the way that you have put it, I think, is the right way. There is a structural factor that has come into the trading system internationally since World War II. This is the value-added tax which is now in place in each of the countries in the European Economic Community and is also in use in 12 other countries, though I would say it is not in widespread use in the Far East. This tax system—the value added tax—rebates at the border the tax on exports and therefore permits those countries to move goods to the United States with a cost advantage relative to our domestic producers. Now, this has been in the structure of international trade for several decades, and I think the system has pretty well adjusted to it. Nevertheless, our people

are disadvantaged by it; and if we do wish to focus on international competitiveness, one action that we could take that might move us to an improved level of international competitiveness would be to permit our tax system to evolve in that direction. Such an action might also serve to redress some of this imbalance that Dr. Makin just emphasized between consumption and saving, which might also be desirable for the economy.

Senator ROTH. I would ask that you and the rest of the panel at the same time address the BTT in that environment.

Dr. MAUER. The BTT proposal is, I think, helpful in that it is something that might fit into our specific institutional legislative environment better than would be required in the case be more exactly in line with the value-added tax. So, it is a benefit in that direction.

Senator ROTH. Thank you. Mr. Pratt.

Mr. PRATT. I would be, generally in agreement with those comments. The value-added kind of a tax, which I would include the BTT as being—in principle with modifications has always had some appeal. Senator Long has lectured to us in the Business Council for years about it, and it does have appeal. It does give you the opportunity to tilt the scales in your favor in export-import relationships; and the business community, which I believe I can speak generally for here, is intrigued by it. However, after analysis, they have always backed away from it—I think largely on the basis that it scares you. One of the biggest objectives that we have in our business community is to try to do things to keep government as small as possible. The fundraising capability of this kind of a tax is so large that, generally, I think the businessman backs away from it because he is afraid you are unlocking Pandora's box. On the other hand, it does answer a lot of the other problems. As I said in my testimony, I think your version of it deserves consideration, particularly in view of some of the needs we face, to find positive offsets for the revenue loss created by tax rate reductions.

Senator ROTH. Thank you, Mr. Pratt.

Mr. LANGDON. I would also undersocre those previous remarks and add that if we do not have some sort of substantial tax reform that meets Senator Long's concern, which is the public perception that industry is not paying its fair share of the total tax burden, this may be one thing that your committee should seriously address. The business transfer tax also goes a way toward solving the deficit problem fairly quickly. Now, some people in business argue that, administratively, that tax is hard to collect. I think really, upon reflection, that the administrative burden is not that great.

Senator ROTH. And finally, Dr. Makin.

Dr. MAKIN. I have addressed this committee previously on the business transfer tax. Let me briefly say that I think is it not a good idea. I think it is a way to try to lable an import surcharge as a consumptive tax. It would produce an inflationary impulse which, if validated by the Federal Reserve, would I think add to some problems we have in that area down the road. The other problem I would raise, and I would second the comments of other witnesses, is that that tax is very expensive to administer; that if we were to impose a consumptive type of that type tax, we wouldn't see a penny of revenue until 1988, if it were to be enacted

today; and once imposed, it is very difficult to dismantle. I don't think it is a particularly good idea.

Senator ROTH. Three to one isn't too bad. [Laughter.]

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Continuing on with the same subject, do you know whether businessmen in other countries who have this kind of a tax system favor it or do they want to change it and go to something else? What is the experience and what are the opinions of foreign businessman with respect to a consumption tax or a business transaction tax? Could each of you respond very quickly?

Dr. MAKIN. Let me briefly say that the experience with administering the system is quite mixed. What you have when you pass a VAT type tax—the first thing you have is what you are going to expect from the tax. That is, you have instant erosion of the base and a lot of pressure to continue the erosion of the base. So, you get into situations where you immediately are seeing the potential revenues reduced——

Senator BAUCUS. But my question is: What is the opinion of foreign businessmen? Do you know the opinions or views of foreign businessmen with respect to these kinds of taxes?

Dr. MAKIN. No.

Senator BAUCUS. All right.

Mr. LANGDON. Our colleagues in Japan and Western Europe obviously have lived with VAT for almost 25 years; and so, in general, they favor it as well as any other tax. I think they are generally in favor of it because of the length of time it has been in place. In our industry, we tend to be fairly highly profitable, and so, our colleagues would tend to be in favor of it because it tends to cut across all industries equally as a revenue raiser.

Senator BAUCUS. Mr. Pratt.

Mr. PRATT. I generally agree—it is a mixed bag. I don't think we shoud consider this as a panacea by any means. It would be difficult to install. It has some administrative problems. It would bring a whole different approach to the concept of how taxes are considered. So, I didn't want to be taken as already supporting it. However it is one of the things, along with looking at everything else, that we need to look at.

Senator BAUCUS. Dr. Mauer.

Dr. MAUER. To a considerable extent, I think the business people in other countries think of their own history when they try to evaluate the goodness or badness of the VAT. And as you know, in Europe they had quite a different system prior to the adoption of the VAT. They had a system of a turnover tax, a national sales tax that did bias the structure of their economies considerably. And I think much of this was cured by the adoption of the VAT—very favorable.

Senator BAUCUS. Let me ask a general question. Let's consider current law. Forget the moment the President's proposal. Let's assume that, as some of you are, you are American businessmen and you want to enhance your international competitive position. What changes would you make in current law—given our political process and our political system here—to significantly enhance American competitive position, if any? We will go down the line. Dr. Mauer?

Dr. MAUER. I would say that we would really be talking about a package of changes all together, not just business. We should be thinking of the President's tax proposal, which goes beyond just the business; but I think that with the changes that were put in place with the 1981 legislation, you have to a considerable extent redressed the problem that we had seen for several decades.

Senator BAUCUS. So, you would say maintain current law?

Dr. MAUER. I would be inclined to maintain. Yes.

Senator BAUCUS. All right. Mr. Pratt.

Mr. PRATT. That is not surprising from what I said previously. That is about where I would be, too. I think some important changes were made at the beginning of this administration, and that is one of the strange things about this action. Important changes were made, and the economy has had one of the biggest resurgences in history; and now they want to change all that. It is a little hard to follow.

Senator BAUCUS. All right. Mr. Langdon.

Mr. LANGDON. I think that the depreciation rules need to be recalibrated more closely to economic lives, to make them more neutral between industries. There are two provisions that Ed Pratt mentioned that are due to expire. They need to be extended. The R&D tax credit and the moratorium on R&D expense under Treasury Regs section 1.861–8.

Senator BAUCUS. All right. Dr. Makin.

Dr. MAKIN. I am not a businessman, but let me try, anyway.

Senator BAUCUS. Certainly.

Dr. MAKIN. This committee probably recognizes, but it should remember, that if you enact measures like you did in 1981 and 1982, which essentially say to the business community: Do something; and then they do it, and then you ask them: Would you like us to change it again? The answer is going to be no. That doesn't really answer the question of whether we can design a better tax system. I think, for the purpose of international competitiveness, we really need to design an stable tax system, one that doesn't get changed every year; and that requires the indexing provisions that are in the President's plan, the indexing of interest income and expense, and essentially a level playing field.

Senator BAUCUS. Would all of you agree that we should move in the direction along the lines that Dr. Makin has suggested? That is, should we treat household expense and income differently? That is, should we change the bias a little bit more toward savings and a little bit away from consumption? Would you all tend to agree with that?

Mr. LANGDON. I would support that.

Dr. MAUER. Affirmative.

Mr. PRATT. In general, business has felt that the Tax Code ought to stimulate investment. It is a little confusing when you start talking about households, and I think this is where the average businessman gets into a little difficult situation. It is an interesting argument as to whether investing in a house is saving or consumption. And a number of people think the difference in saving ratees between here and Japan can be looked at in quite different ways if you take a different view. What better saving than to create ownership in a growing asset like a house?

Senator BAUCUS. Thank you.

Mr. PRATT. To call that consumption and to say that the Japanese are right because they are not stimulating that is, it seems to me, at least debatable.

Senator BAUCUS. Thank you very much.

The CHAIRMAN. Max, it is interesting that Mike Stern and Bill Diefenderfer were just in Europe over the holidays, talking with the governments, and specically about the value-added tax, not the business leaders but the governments. I haven't talked to Mike yet, but Bill indicates that all the governments like the tax and they are satisfied with it; and also, many of them offered the opinion that they didn't think we would ever go to it because they didn't think we had the political will to do so; but indeed, if we did, it would make us more competitive vis-a-vis them.

Senator BAUCUS. That fits what I hear, too.

The CHAIRMAN. Yes. Senator Long.

Senator LONG. Thank you, Mr. Chairman. Mr. Pratt, you are here at a good time to say what you said in your statement, which may I say is, as far as I am concerned, a terrific statement because I agree with everything in it. [Laughter.]

The CHAIRMAN. Could I interrupt just a moment? Mr. Pratt has to leave no later than 11:30.

Mr. PRATT. Senator, actually that has been changed.

The CHAIRMAN. Oh, it has been?

Mr. PRATT. Yes, Senator.

The CHAIRMAN. All right.

Senator LONG. I agree entirely with your logical sugestion that it would be far better for us to take a little more time—let's say to go on over to next year, if need be—in the hope that we could come up with the best answers to these difficult problems, rather than get involved in what I call the bum's rush. Some folks are saying: "Oh, no, we have to get this thing done now. We have to be able to tell the people we did something in this session." If we do, we may wind up doing something that we are not too happy with.

It dismayed me to see that the people who agreed with the President of the United States the most about Social Security supported important measures in that Social Security package which, in my judgmet, were not in the national interest. So, I wound up voting the same way Joe Wagonner did on the Commission. Joe Wagonner was a conservative Democrat selected by the President to be on the Commission. He refused to sign the report, and Mr. Archer was in that position as well. So, some of the President's strongest supporters refused to sign it because they didn't agree with it. And yet, we were asked to pass it, thinking that it was the best that could be done. I think we could have done better.

Basically, you have implied in your statement that we should not throw out the baby with the bath water; that insofar as we have provisions in that Tax Code that make a lot of good sense, that we shouldn't just throw them out in the name of reform, when we might wind up with a less satisfactory answer to the problem. Is that basically what you are saying in your statement?

Mr. PRATT. Yes, Senator.

Senator LONG. Now, you haven't mentioned this, but I think you might want to comment on it. I wouldn't be the least bit surprised

to see us, if we rush to judgment on this thing, in conference with the House, with the House having breathed life back into a whole lot of provisions in Treasury I that died in Treasury II, particularly some that you might fear the most. Would you mind commenting on some of the things in Treasury I that you would most hate to see come back to life?

Mr. PRATT. Oh, gee. [Laughter.]

I am trying to forget those. [Laughter.]

Senator LONG. Maybe we could offer you an opportunity to come back and testify again, if the need be. You can see some cause for concern, I take it?

Mr. PRATT. Yes. I have that concern.

Senator LONG. Now, let me just make this comment and get your thought about it. It seems to me that Lester Thurow is right when he supports Senator Roth's business transfer tax and supports a value-added tax. Mr. Thurow makes the point that is not really necessarily that you look for the fairness of the tax but what the overall impact of your system is. In other words, from his point of view—and I think this is correct—that as far as fairness is concerned, it is the mix that decides whether the tax system is fair or not fair. For example, Mr. Thurow would like to have a negative income tax so that a low income family making, with let's say, a $10,000 annual income would have a tax credit that would mean that the so-called value-added tax, or anything that is a tax on consumption, would in effect be refunded to them by way of a negative income tax. We have something similar to that in the earned income credit in the law. By his argument, you could make it as liberal or as conservative, or you might say, as much oriented toward the low income people, as you want to. However, in working out what your overall tax arrangement is, if you like the idea of a value-added tax approach, it can be one that has no impact at all on the low income people and the poor, or it could be one that has whatever impact you want it to have, by coupling that with a negative income tax. Do you see what I am talking about?

Mr. PRATT. Yes, I do. Of course, that is in my judgment one of the most to-the-point comments about why our Tax Code is complex. There is no tax answer so simple that you can just put it in and say this is going to do the job. You are going to raise all these kinds of questions, and I think rightfully so. Any kind of tax that we are going to put in is going to raise this kind of question. You are going to have to be concerned about the poor. You are going to have to be concerned about the effect on our international competitiveness. You are going to have to be concerned about the effect on industries that we may want to sustain in this country and yet need special incentives to be sustained. I should say again that most of the things I have been talking about don't relate to my company. We are not a smokestack industry. We don't have to deal with a lot of these issues. I have really been trying to address it from at least my own view as a businessman about its impact on the total business atmosphere in the country.

Senator LONG. I would just like to ask one brief followup question. Some people have made the point to me that, if we had anything that is a tax on consumption, we ought to exempt drugs, perhaps food, and things like that from it. My inclination is that, inso-

far as the poor are concerned, the overal mix should be such that it would not just eliminate drugs—it should have no impact at all on the poor. It is possible to do that with a negative income tax that accompanies the consumption tax. So, from that point forward, you can do whatever you want to do with it; but just for simplicity and uniformity, it would seem to me that the person in the tax category of the ordinary Senator and Member of the House should not exempt for anything. He would pay a tax on all his purchases because he can afford to. Those who are low-income people can be given whatever consideration you want to when you work out such a proposal. I just don't think that that type of tax approach need be condemned on the theory that it impacts on the poor because it need not impact on them any more than you want it to impact on them.

Mr. PRATT. I understand your point, Senator. I would certainly agree with that.

Senator LONG. Thank you, sir.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Pratt, in your testimony, you stressed, as well all have been stressing here--certainly on the Republican side of the Senate—the urgency for deficit reduction. Regardless of the effect on the dollar, we ought to do it. My question is this: What do you think the effect on the dollar would be if we went along a path toward eliminating the deficits by 1990, with substantial reductions in 1986 and through 1988?

Mr. PRATT. Here, again, surrounded by economists, I know economists have all got different views on that. As a practical businessman, my common sense tells me it ought to have a favourable effect. I think all businessmen feel that way strongly—that the deficit is indeed one of the major problems contributing to our interest rates and the dollar, although this is disputed by some knowledgeable people. So, yes, I would think that would be an important factor. I have come to the conclusion that, regardless of what we do, I think the dollar will adjust. I think that the very size of our international balance of payments deficits will mean the long-term strength of the dollar will eventually take a turn, just like it does with every other country. And nations and people will be, therefore, more concerned about the future of the dollar, and they will do the same thing we businessmen do. Once they think that the dollar is finally going to adjust, they are going to get out of it as fast as they can. Now, people will say where are they going to go? And I agree, it isn't easy. But there will certainly be a sizable effort to get out of the dollar and it will have some effect, and it will adjust. However, I think the longer we wait, the more difficult that adjustment will be. It looks like it may be under way already, as some people are suggesting. Maybe it is. I hope so. I have been concerned that even with deficit reduction, the adjustment would not happen fast enough and I, at least, have suggested that we ought to even consider new approaches that, in the past, may have been considered impractical, and yet seem to me may be desirable. One possibility may be negotiated exchange rates. They are doing some of that in the Common Market, as you know. They negotiate ranges of relationships between currencies. I suspect a more dramatic attack on the actual value of the dollar is justified in view of

the difficulty it is causing all over the world. The dollar is killing us—the American businessman. It is killing us, and we can't, in my judgment, tinker with something here with the thought that by 1992 it will solve the problem. We need more abrupt improvements than that. I would consider things that, up to now, have not been considered.

Senator CHAFEE. What do you say, Dr. Makin?

Dr. MAKIN. I think there are constructive and destructive ways to get the dollar down. Right now, this economy is heading in the destructive direction. The economy is slowing down rapidly. That will get the dollar down. Money growth is accelerating. That will get the dollar down. And unfortunately, despite the efforts of many sincere people, we are not getting action on the deficit. And if that contributes to the slowdown, that might even get the dollar down, but I am not sure that is the outcome we want. We want a constructive——

Senator CHAFEE. We all agree that is not the outcome we want. I guess taking the reverse side, all of us believe we ought to reduce the deficits, but an odd part of reducing the deficits might be that the dollar would be strengthened.

Dr. MAKIN. I strongly urge you to take the chance.

Senator CHAFEE. We are willing to take that chance. [Laughter.]

And we have indicated that. Let me ask you quickly—and this is sort of along the lines of what Senator Baucus asked—and that is: What is good about the proposal? Mr. Langdon, I am talking about the President's tax proposal. Yes, you would like making the R&D tax credit permanent. What else do you see that is good about it?

Mr. LANGDON. Yes. I think there are several things that are good about it. One, substituting a more realistic depreciation system, which then eliminates the tax differential between various industries. You probably saw the Joint Committee report which gave a range of effective tax rates between industries, which was very dramatic. that really results in an inequitable distribution of capital within industries within the United States.

Senator CHAFEE. Would you agree with that, Mr. Pratt?

Mr. PRATT. I commented on that earlier. If I were speaking for Pfizer, I would say by all means. You know, we are not a smokestack industry or the kind that tends to benefit from accelerated depreciation. I have a little trouble with that, though. I am not sure that this differential treatment between various industries is necessarily bad. I am not sure. I think it may be important for us to stimulate industries that need stimulation.

Senator CHAFEE. Dr. Mauer, what would you take out of the President's proposal? You don't like it, but what would you take if you could take something? I know you would take the R&D tax credit. What else?

Dr. MAUER. Perhaps it is in order to respond to one of my fellow panelists who mentioned, or emphasized, that there were discrepancies in the allocation of capital across investment categories as a result of current law. I would feel, with my colleague, Mr. Pratt, that this indeed is warranted because there has been a major problem in the system as it had been earlier constituted that offered a bias against those large capital users. And we have much of that

now redressed under present legislation. Your quesion is which provisions are desirable?

Senator CHAFEE. Yes. I mean, we are going to be sitting here deciding, and if we follow through on Mr. Pratt's skeptical view that you can't keep Congress from tinkering with this thing anyway, maybe we ought to at least know what is good about tinkering.

Dr. MAUER. Yes. I think one of the things that I am inclined to support in the tinkering area, and I feel it is something more than tinkering, is a point that has been mentioned by Dr. Makin. And that is that it is desirable to index your capital recovery system. That concept has merit, and it has merit especially should we again move to inflation rates that are in excess of 10 percent. I myself feel that, if you take a long view of things, it is possible that we might again see inflation over 10 percent sometime during the next, say, 20 years.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman. Gentlemen, this is a very interesting subject. Clearly, if we wanted to encourage more exports and fewer importss, we would have a Tax Code which would encourage savings and reduce the interest rates. Dr. Makin, you have made a proposal in your testimony which is similr to what was proposed—or identical, I guess, to what was proposed—in Treasury I, relating to indexing of the interest deduction for borrowers and interest income for lenders. Can you explain how that would work and why what would both encourage savings and reduce interest rates?

Dr. MAKIN. I did try to answer that before, but to use Senator Packwood's expression, I don't think I did a very good job.

Senator DANFORTH. I am sorry. I wasn't here.

Dr. MAKIN. Let me try again. Let me give some examples of what Treasury I suggested. Let's say that you are a saver and you are earning 10 percent interest. About 6 percent of that is compensation for the fact that inflation is going to erode the value of your saving. And so, there is no real compensation there. What the Treasury proposal tried to do was to say that you really shouldn't be taxed on what is compensating you for erosion in the value of your saving. So, they would take out the inflation component and tax only the real component. So, in a way, you would encourage savers by saying to them, look, you are not going to lose out. You are not going to be taxed on simply the inflation portion of what you are earning. You are just going to be taxed on the real portion. I think this is an important area because, when you think about why people save, then think about the aftertax return to saving.

Senator DANFORTH. What would happen to the interest rates with this proposal?

Dr. MAKIN. Because you would encourage more saving, the supply of funds available in the financial markets would rise, and there would be a drop in the interest rate. At the same time, you are saying to borrowers: You are not going to get a gift if inflation accelerates. In other words, you will only be able to deduct the real portion of your borrowing, not just the nominal portion.

Senator DANFORTH. The disincentive to borrowing is an incentive to saving?

Dr. MAKIN. Yes.

Senator DANFORTH. And it says also to lenders that you can get the same aftertax income by charging more interest rates?

Dr. MAKIN. Exactly. That puts it better than I put it, frankly.

Senator DANFORTH. Now, is this too complicated?

Dr. MAKIN. I don't believe so. I read a number of the commentaries to say this is complicated. One of the things that complicated it, and I think this comes to a very central issue in any discussion of tax reform, was that the Treasury I, under instructions from the President, exempted interest expense for owner-occupied housing. And there was a good deal of concern that this exemption would lead to abuse. That is, if the only way to get fully deductible interest expense is through principal residence, the size and investmen in principal residences would increase considerably. So, I think concern about that loophole rationalized doing away with the whole thing; and it was sort of like saying there is a hole in the fence, and we are afraid people will slip through it. So, we will throw away the fence instead of plugging the hole. Here again, I think you would have to do it consistently. If I may add, I think there may be a way to get at this. Going at this cold turkey may be too hard. A general way to approach many of the problems we have discussed today would be to follow the approach that has been suggested where you take a deduction, or you take an exemption or an exclusion, and you evaluate it at, let's say, the lowest marginal rate—15 percent. And then you turn it into a credit and then tax gross income at lower rates. This would have the effect of phasing in, effectively, indexing of interest expense and phasing out some of the special tax provisions that are revenue losers.

Senator DANFORTH. How do the rest of you feel about this idea of indexing?

Mr. LANGDON. From a corporate perspectie, it is fairly easy for companies to comply with indexing, and I think that a lot of the intended results that Dr. Makin points out will occur. The complexity issue, though, I think is a very major one with regard to individuals. And I think the major problem that our Tax Code has today is the high percentage of individuals who require outside assistance in order to do their tax returns. Putting indexing into the capital gains provision is going to increase rather than decrease complexity for individual taxpayers.

Senator DANFORTH. Dr. Mauer.

Dr. MAUER. I share Mr. Langdon's feelings.

Mr. PRATT. I think I would be about the same, Senator. I don't have strong feelings about that, and I haven't really thought a great deal about this one, I have to admit.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Makin, I take it that, in fixing the fence, you would also prohibit deductibility of home mortgage interest?

Dr. MAKIN. No.

The CHAIRMAN. You would allow that?

Dr. MAKIN. I am sorry. I would treat home mortgage interest exactly like all the others.

The CHAIRMAN. Like all the others? All right. Now, you made some reference, as have many of the economists, as to the Japanese savings rate, and I think you referred to it as being three times

ours; and that is roughly it. We have tried over the years a whole variety of savings incentives. Senator Danforth, what was the one you had for the savins and loans some years ago?

Senator DANFORTH. The all savers certificate.

The CHAIRMAN. Oh, the all savers certificate. That is right. Everything we have tried doesn't seem to work. the savings rate doesn't go up very muhc. In fact, we reached a high in this country of around 8.2 or 8.3 percent in the early 1970's, but we have never really been a high savings country. Are you suggesting that, in order to encourage that, instead of those potpouri of savings incentives that we have, that we have basically consumption disincentives which would automatically result in increased savings?

Dr. MAKIN. You could say that. Yes. I would say that you can say that too little saving is the same thing as too much consumption.

The CHAIRMAN. What I am getting at is this: How do we know that consumption disincentives would result in increased savings? Savings incentives have not resulted in increased savings.

Dr. MAKIN. Let me address that. The savings incentives that have been put into place are largely the so-called IRA or retirement savings incentives. The problem with these is that they don't operate comprehensively. What we find when we look into the result is that the bulk of the response is by people who have stocks of saving already on hand and every year transfer $2,000 or $4,000, whatever they are allowed, from existing savings into their IRA account and take the deduction. In order to increase saving, it has got to be made more attractive. Let me put it another way. Suppose you were a person who, between 1975 and 1980, saved your money? You said, well, my neighbor rushed out and bought a house, but I really can't afford it yet. I am going to save my money. By 1980, you felt like a fool because the person who rushed out and bought a house in 1975 got a 6-percent mortgage, bought a house that doubled in value, and essentially was strongly reinforced; whereas you, saving up for your house, maybe bought a 5-year bond that earned 6 percent. In effect, after inflation and taxes you earned a negative rate of return. So your accumulation of financial assets was a big loser. In order to encourage saving, you have got to essentially foregoing current consumption, and that means having a fairly stable inflation atmosphere. It also means taking away some of the subsidies that are currently there to consume. And again, our tax treatment of interest income and expense is a big one.

The CHAIRMAN. Why did this country do so well in the 1950's and 1960's in terms of productivity and export, and we still had a low savings rate? What went wrong? The savings rate didn't change. Why were we so good in that roughly 20-year period—1950 to 1970?

Dr. MAKIN. Partly, I think it is a relative matter. Remember that in the 1950's this country was the only country that had its capital stock fully intact. Again, take the case of Japan. Let the number 100 represent real per capita income in the United States in 1980. Japan, before World War II, was at 12. After World War II, they were at six. In other words, the war essentially destroyed half of their capital, and a similar thing in Europe. Now, Japan is back up to 80, and one of the reasons they have had much higher saving rates and much higher rates of capital formation is that they have

had a much longer way to go. The United States looked particularly good in the 1950's because our potential competitors were still building, while we were, in effect living on capital. Now that our competitors have rebuilt, we don't look so good any more, because they have rebuilt in some cases with more modern capital. They have instilled habits which are oriented toward providing more for future consumption, whereas we have instilled habits which are aimed at consumption.

The CHAIRMAN. But how did we do it domestically? Forget export. Forget the competition. How did we manage to grow at a productivity of 2.5 to 3 percent and make significant domestic capital investments? Where did we get it? It wasn't foreign investment particularly.

Dr. MAKIN. We were exporting. I am not saying that this isn't a lively and dynamic economy. I am just saying that——

The CHAIRMAN. Comparatively speaking to our GNP, we were exporting relatively little in the 1950's and not much more in the 1960's, but somehow we amassed capital in this country and created businesses and expanded and produced jobs, and productivity increased. I am curious as to where we got the money.

Dr. MAKIN. We got the money essentially from domestic savers.

The CHAIRMAN. We didn't have a high savings rate though. We had about 5.5 to 7 percent.

Dr. MAKIN. You know, I would have to go back and look at the numbers, but I believe our savings rate was, on net—that is, when you adjust for capital consumption—a good deal higher in the 1950's and 1960's than it is now.

The CHAIRMAN. What do you mean? The only savings rate I am talking about is the one that I can get from the Treasury Department or the Congressional Research Service, and I assume that they give it to me apples and apples, year after year, because that is the way I ask for it.

Dr. MAKIN. But which savings rate did they give you? In other words, did they give you a saving rate that adjusts for the amount of saving we have to do just to stay in the same place?

The CHAIRMAN. The savings rate they give is the percentage of savings in relation to the GNP, and it includes equity and insurance and bank accounts and everything else. It includes capital stock purchases.

Dr. MAKIN. They gave you a gross savings rate?

The CHAIRMAN. Yes.

Dr. MAKIN. Which is a bit misleading over time, but I don't want to avoid your question. Where did the savings come from in the 1950's? The saving came largely from domestic sources. American industry was building rapidly, with great potential in the world economy, where we were well ahead of our foreign competitors. America itself is a great marketplace, and the 1950's was the time when American businesses could develop products and effectively think about marketing them at home and sourcing them at home.

The CHAIRMAN. Thank you. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. The committee has heard from a lot of witnesses about the trade deficit and the tax system and about ways to try to counter the deficit. And while that is not directly the issue of this panel, it is related because the ques-

tion yo have to ask is: How are we going to compete in international markets? I was curious as to whether you believe that if what we are interested in is competitiveness, is it the overall efficiency of the economy that is important, or is it the specific tax breaks that are given to achieve specific objectives? Dr. Makin and then anyone else?

Dr. MAKIN. This won't be a surprise. I think it is the overall efficiency. Let me suggest one other piece of information. In 1985, the value of tax expenditures going to American corporations was $95 billion, as estimated by the Joint Tax Committee.

Senator BRADLEY. What was that? Say it again.

Dr. MAKIN. If you take all the tax expenditures going to the corporate sector in 185, it sums $95 billion of lost revenue. Now, take Japan. Here I am trying to illustrate my case that even this is better than special incentives. In Japan, that same number is the equivalent of $1.5 billion.

Senator BRADLEY. In tax incentives?

Dr. MAKIN. In tax incentives.

The CHAIRMAN. So, they use their tax code very heavily——

Senator BRADLEY. Very little.

Dr. MAKIN. Very little.

The CHAIRMAN. Oh, very little. Oh, $1.5 billion you said. I am sorry.

Dr. MAKIN. $1.5 billion versus $95 billion.

Senator BRADLEY. And?

Dr. MAKIN. Japan is a rather effective competitor in the world marketplace, and they have what I would judge to be a fairly even-handed tax system when it comes to the corporate sector.

Senator BRADLEY. Dr. Mauer?

Dr. MAUER. Yes. Reacting in part to Dr. Makin's comments, I feel that it is very difficult to compare one economy with another; and these comparisons are difficult at many levels. One of the major levels is not the comparison of the tax system—U.S. vis-a-vis Japan—but rather a comparison of the process through which capital is raised and allocated. In Japan, you have got a number of factors that contribute to much lower capital costs from an interest rate standpoint than you have in this country.

Senator BRADLEY. I thought you didn't want to compare them.

Dr. MAUER. I am saying that these comparisons are difficult, and I am pointing out one of the difficulties with John Makin's focusing strictly on the tax systems.

Senator BRADLEY. Would you see if you can return that deep shot to the base question? [Laughter.]

Dr. MAKIN. Let me see if I can. The studies that I have seen on the cost of capital in Japan—one recently completed by Prof. Allen Auerbach and Professor Andos—suggest that user cost calculations as a relevant figure for capital formation are roughly equivalent in the United States and Japan.

Senator BRADLEY. That is what Dr. Auerbach testified before the committee several weeks ago. So, that is right. So, you believe that efficiency is more important than tax breaks. The queston is: How do you describe efficiency in language, you know, that everyone understands?

Dr. MAKIN. Let me put the efficiency in terms of looking at the President's plan. I think of both dimensions. We want to think about how we allocate capital and whether we encourage or discourage capital formation overall. The President's plan produces a 50-percent reduction in the dispersion of tax burden across different uses of capital.

Senator BRADLEY. What does that mean?

Dr. MAKIN. OK. Let me put it in the way I was thinking about it in my testimony. Suppose you have an engine and you want to increase the horsepower. You need to increase both the air and the fuel input. And if you do it with the right mix with a supercharger, you will get more horsepower. So, let's say that the tax incentive is the supercharger. Let's say we put all the incentives in one area. It is like dumping more fuel into the engine without any more air. It is going to sputter. You have got to keep the mix right. So, the mix is important and, of course, the overall level of the air-fuel mix that is going in is important. So, when people talk about neutrality, they are talking about the mix of fuel and air. When they talk about investment incentives overall, they are talking about how much of that mix is going in. In my judgment, the President's proposal keeps enough going in and greatly improves the mix.

Senator BRADLEY. So, you are defining efficiency in terms of essentially the most efficient mix—in your analogy—and in economic terms, theat the combination of things should be as neutral as possible in influencing the allocation of capital and investment. And therefore, the market should perform that function. Is that correct?

Dr. MAKIN. Exactly. Neutrality says if you want to make a decision, make it based on its fundamental soundness for the business. You don't have to call up the tax department.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Gentlemen, do we have a high enough level of R&D in this country?

Mr. LANGDON. Absolutely not, from several perspectives. One, they key thing in our view that fuels exports is R&D activity in this country. The closer you can have your R&D facility to your manufacturing facility, the better you end up with a product. And what has happend abroad within the last few years is that our other major trading partners—Japan, France, and the United Kingdom—have enacted very generous R&D incentives so as to counterbalance the R&D efforts in this country because they realize that, if they get on the cutting edge of technology in all sectors of manufacturing, they will leap ahead of us. And they are constantly at our heels because their wage rates are substantially lower than ours.

Senator BAUCUS. In addition to make the R&D tax credit permanent, would you advocate either raising the R&D tax credit or making any other changes?

Mr. LANGDON. I think that the President's proposal is correct from the standpoint of more finely tuning the definition so that it only relates to innovative projects. I think conceptually it is sound in that it provides an incremental credit which rewards people who increase the amount of R&D activity. I don't think that it is necessary to make it any richer.

Senator BAUCUS. So, you think it is all right?

Mr. LANGDON. Yes.

Senator BAUCUS. The proposal is fine?

Mr. LANGDON. Yes.

Senator BAUCUS. Do any of the others have any comments on the level of R&D in the United States?

Dr. MAKIN. I have one prediction.

Senator BAUCUS. All right.

Dr. MAKIN. The R&D tax credits will increase the number of investments that are defined as R&D.

Sentor BAUCUS. That is always a problem. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you, Mr. Chairman. I have had my shot at this, and I want to thank the witnesses, but I have no further questions.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. I have just one more question. I am curious still on this competitiveness thing. Do you think if you tried to determine which was more important in terms of competitiveness, how would you order the exchange rates and the impact that has on competitiveness versus the Tax Code? Again, you frequently find the argument made that we hav this big deficit and what we need are more tax incentives. Can you overcome the disadvantage of an overvalued dollar with tax incentives?

Dr. MAKIN. No. I think there is concensus on that.

Mr. LANGDON. Yes. We all agree on that and we also said, from all of our testimony at the beginning, that we felt that the deficit was more of a major priority than dealing with various and sundry tax reform proposals, especially in the area of international competitiveness because it fuels the strong dollar.

Senator BRADLEY. Thank you.

The CHAIRMAN. Gentlemen, thank you very much.

[Whereupon, at 11:53 a.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

CSI

SHaaT July 18

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IMPACT OF ADMINISTRATION TAX PROPOSALS ON

FOREIGN TRADE OF INTERNATIONAL SERVICE ORGANIZATIONS

The President's tax reform Proposals of May 28 would impose a non-elective per-country limitation on the foreign tax credit and would change many of the rules for determining the source of items of income. These changes would dramatically alter the tax treatment of U.S. taxpayers that derive overseas income and foreign taxpayers that derive income from activities in the U.S. We believe that the proposed changes would undermine the ability of domestic concerns to compete in high-tax foreign countries. In addition, the Proposals would have a particularly harsh impact upon service corporations because of the unique nature of the international service business (as opposed to the manufacturing industries at which the proposed rules appear to be aimed). Some of the anticipated effects of the Proposals are discussed below.

Impact Upon U.S. Owned International Service Corporations

- The international service business must make its services available at the location where the client's needs are to be satisfied or the service is to be consumed or utilized. Unlike manufacturers who may produce in one country for consumption of their produce in several other countries,

service businesses generally cannot elect a low-tax jurisdiction to produce their products for markup or sale to other jurisdictions.

- To compete effectively on an international scale, most international service businesses must be able to offer a world wide service on an integrated basis. Service businesses normally follow their clients around the globe. This often entails providing services in as many countries as possible regardless of tax rates, exchange restrictions, or even the ability to turn a profit in many parts of the world.
- An exception to the practice of rendering services in the location where they are used occurs in the technical assistance area, where the user country (generally less developed) is seeking services of highly technical nature from a more sophisticated country in which such expertise is available. This technical assistance service exception to the general practice currently presents a classic double-taxation problem under present law which, while taken into consideration under the proposals, is not adequately resolved.

- As a matter of tax policy, the per-country proposal removes from current law a system responsive to the problems of the service sector without meeting the Proposals' stated objective of eliminating the incentive for manufacturing and industrial concerns to locate in low-tax jurisdictions.

- Manufacturing or industrial concerns could still choose low-tax jurisdictions for production with the products actually being consumed in other countries. Profits could be accumulated for reinvestment in those low-tax jurisdictions without repatriation to the United States.
- In addition, according to the text of the President's Proposals, the revised sourcing rules would also attach greater significance to the jurisdiction in which the property is manufactured than to the location where the sales activities occur. (See Appendix for illustrations for these effects.) This would increase the incentive for domestic concerns to locate manufacturing facilities abroad in lower tax jurisdictions.

- By increasing the cost for the Service sector to render services in high-tax countries, per-country limitations as imposed by the Proposals could cause a reduction in the amount of services sold in such countries. The Proposals could therefore be detrimental from a balance of trade standpoint.
  - A worldwide calculation of foreign tax credits enhances the ability of U.S. taxpayers to compete in high-tax countries. This result occurs because taxes from such countries can be offset against profits from low-tax jurisdictions, reducing the total cost of selling products and services.

- An international service business may continuously incur losses in some countries because of its overriding necessity of maintaining a global presence. If these operations are conducted through foreign branches, as is often the case, the current system of offsetting foreign losses directly against foreign profits when computing foreign source taxable income in making the foreign tax credit calculation is far more sensitive to the worldwide nature of an international service business than the proposed system of offsetting losses.
- Under the proposed per-country system, these purely foreign losses would be partially offset against income from high-tax jurisdictions where the excess credits cannot be utilized to reduce the overall foreign tax cost. By not fully tax-effecting loss operations, the Proposals would penalize service business for fulfilling the competitive business need to maintain a presence in as many countries as possible.

- The proposed rules would be administratively unworkable for domestic taxpayers with international operations.
  - In determining their foreign tax credit, taxpayers would be required under the Proposals to allocate income on a country-by-country basis and then to apportion expenses and losses to such income. For example, income derived from activities occurring in

more than one country would have to be allocated among all of the countries in which such activities take place. Moreover, expenses such as overhead, stewardship, and interest would have to be apportioned among such countries. Consequently, the Proposals would give rise to a substantial additional record-keeping burden.

- Due to the inherent subjectivity of allocation and apportionment, the proposed rules would probably cause increased litigation on the part of multinationals who do not capture data on this level of detail.
- Taxpayers are presently required under present law only to allocate and apportion income and expense items between U.S. and non-U.S. sources.

Double Taxation - Technical Assistance Contracts

Under current law, income which is attributable to personal services is sourced in the jurisdiction in which the services are performed. In many instances where these services are of a highly technical nature, developing companies are seeking the services from more developed societies. Consequently, services may be rendered outside the jurisdiction where the end product (a factory blueprint, computer program, feasibility study, etc.) will be utilized. For example, technical services are frequently rendered within the United States, creating U.S. source income, while the gross payment for the service is subject to taxation in the country in which the service is utilized. Third world

countries are not likely to have double taxation agreements with the United States, and often levy taxes on the gross payments for these services performed outside their boundaries.

- These conflicts between sourcing rules of the United States and foreign countries lead to economic double-taxation. Such double-taxation hampers our service companies' ability to compete against major competitors which have more favorable foreign tax credit systems that unilaterally recognize this double-tax problem.
  - The inability to bid competitively on technical assistance contracts impedes the ability of the technical assistance segment of the service sector to create additional jobs in the United States and exacerbates our balance of trade problems.
  - The President's Proposals recognize that this service problem occurs in the case of architectural engineering and related constructions services. The Proposals fail, however, to ameliorate the problem for management consulting, computer software, accounting, insurance brokerage, information systems analysis, marketing consulting, communications systems, and seismographic and other geophysical service systems in which the United States maintains a leading technical edge, but cannot effectively compete because of the double-taxation problem.

- The President's Proposals are helpful in that they would permit taxpayers to elect on a country-by-country basis whether to deduct or credit foreign taxes. Consequently, a taxpayer could obtain a deduction for foreign taxes in countries where it may have no foreign income or loss without losing the ability to take credits for other countries.
  - However, we do not support the President's per-country proposals for the foreign tax credit, and we do not believe that the Treasury would permit a per-country election between deduction and credit if the President's proposal is unacceptable to Congress. Therefore, we suggest that the double taxation problem be resolved even if the per-country proposal is found unacceptable to Congress.
  - We recommend that the sourcing rule for income derived from technical service contracts be conformed to the source rules for rental or royalty income derived from intangible property (i.e., such income would be sourced by reference to the place where the intangible product of services is utilized). This would put our technical service sector on a competitive footing with the tax laws of many of our trading partners.

Branch Profits Tax

- The proposals would provide a deterrent to foreign entities from locating facilities in the U.S. In addition, facilities that are presently operated as domestic branches might become economically unsound under the proposals. This disincentive to locate in the U.S. would result from the "branch profits tax" that would be imposed upon deemed repatriations from U.S. branches of foreign corporations.
  - The branch profits tax would increase the tax cost to foreign taxpayers of doing business in the U.S. Consequently, foreign corporations would be induced to save taxes by locating facilities outside the U.S.
  - The branch profits tax could potentially impose a triple-tax upon a U.S. shareholder of a controlled foreign corporation which is conducting business in the United States through a branch.
- The proposals would repeal the "80-20" rule regarding interest of dividends from U.S. corporations. This revision in the dividend and interest sourcing rules might impede foreign investors' willingness to invest in certain corporations carrying on operations in the U.S. The change would also create an unfair distinction between a U.S. incorporated bank and other financial entities (e.g., a U.S. incorporated 80-20 lite insurance company which issues policies solely to non-resident aliens who are residents of non-

treaty countries) since interest paid on those life and annuity policies would be subject to the 30% withholding tax while interest on any bank deposit by a non-resident alien is currently exempt from U.S. taxations.

- Although "80-20" corporations must by definition derive most of their income from non-U.S. sources, some of their income may be attributable to U.S. operations. The proposal would increase the required pre-tax return for equity or debt investments in these corporations.

APPENDIX

EXAMPLE: Assume that Company A is a domestic manufacturer of computers and office equipment that has decided to market its products in the Far East. Company has determined that, from a strategic standpoint, it should market a line of products in Japan for the next few years. The company has forecasted annual Japanese sales of $10,000 for the product line. Units for each year's far east sales can be produced at A's domestic facility for $5,000. Alternatively, A could establish a Hong Kong facility to produce them at a total yearly cost of $5,500.

Company A's present operations are expected to yield $1,000 U.S. source taxable income and $2,500 of taxable income from French sources. France, Hong Kong, Japan and the U.S. impose income taxes at flat rates of 50%, 16%, 42% and 33%, respectively.

Company A would recognize annual taxable income of $8,500 if the manufacturing operations are conducted domestically. It would pay taxes of $2,100 to Japan and $1,250 to France each year. It would have an annual tentative U.S. tax liability of $2,805 which, after reduction by a foreign tax credit of $1,650, would result in a total U.S. tax liability of $1,155. Consequently, A would pay a total of $4,505 domestic and foreign taxes each year, leaving it with after-tax income of $3,995.

If per-country limitations are instituted and the income sourcing rules are changed as the President proposes, A's total annual foreign tax credit would be limited to $1,237 ($412 from Japan and $825 from France), resulting in total U.S. tax liability of $1,568 ($2,805 tentative tax less $1,237 of credit) for each year. A's annual after tax profit would therefore be $3,583 under the President's proposals if it conducts its manufacturing operations in the U.S.

As mentioned above, A could produce its product line in Hong Kong at a total annual cost of $5,500. Because of the additional cost of manufacturing overseas, A's annual pre-tax income would be only $8,000. However, A's U.S. taxable income would not include amounts received from Japanese sales. Therefore, A's U.S. taxable income would be only $3,500, and A's foreign tax credit would be $825 (attributable to France). Consequently, A's annual U.S. tax liability would amount to $330, and A's annual worldwide tax liability would be $4,190. A's after-tax net income for each year would consequently be $3,810.

In summary, A's after-tax profit under current law from producing the product line in the U.S. and selling it in Japan ($3,995) would be greater than the amount that it would earn from producing its goods in Hong Kong ($3,810). However, its profit where the product line is produced in Hong Kong is greater than the profit that would arise from manufacturing its product line in the U.S. if the President's Proposals are adopted ($3,583). Con-

sequently, economics would dictate that A establish the Hong Kong facility if a per-country limitation is adopted. In such event, the U.S. would lose direct tax revenue of $825 from A, as well as indirect economic benefits (e.g., employment).

The table on the next page presents the assumptions and alternative calculations of A's foreign tax credit.

APPENDIX - Continued

	Worldwide Limitation		Per-Country Limitation	
	Manufacture in U.S.	Manufacture in H.K.*	Manufacture in U.S.	Manufacture in H.K.*
Japanese sales (gross)	$10,000	$10,000	$10,000	$10,000
Allowable expenses	5,000	5,500	5,000	5,500
Net Income Sales	$ 5,000	$ 4,500	$ 5,000	$ 4,500
Foreign Source T.I.:				
Japan Source**	$ 2,500		$ 1,250	
French Source	2,500	$ 2,500	2,500	$ 2,500
Total	$ 5,000	$ 2,500	$ 3,750	$ 2,500
U.S. Source T.I.:				
From Japan Sales**	$ 2,500		$ 3,750	
From U.S. operations	1,000	$ 1,000	1,000	$ 1,000
	$ 3,500	$ 1,000	$ 4,750	$ 1,000
U.S. Taxable Income	$ 8,500	$ 3,500	$ 8,500	$ 3,500
U.S. Tentative Tax	$ 2,805	$ 1,155	$ 2,805	$ 1,155
Foreign Taxes:				
Japan	$ 2,100	$ 1,890	$ 1,100	$ 1,890
Hong Kong		720		720
France	1,250	1,250	1,250	1,250
TOTAL	$ 3,350	$ 3,860	$ 3,350	$ 3,860
Foreign Tax Credit:				
Overall	$ 1,650	$ 825		
Japan			$ 413	
France			825	$ 825
Total	$ 1,650	$ 825	$ 1,238	$ 825
Federal Income Tax Liability	$ 1,155	$ 330	$ 1,568	$ 330
Income Summary:				
Income-U.S. Operations	$ 1,000	$ 1,000	$ 1,000	$ 1,000
-French Operations	2,500	2,500	2,500	2,500
-Far East	5,000	4,500	5,000	4,500
Total	8,500	8,000	8,500	8,000
Less: Taxes	4,505	4,190	4,918	4,190
AFTER TAX PROFIT	$ 3,995	$ 3,810	$ 3,583	$ 3,810

* Manufacturing operations would be conducted by a Hong Kong subsidiary. Cash profits would not be repatriated.

** Under present law, income sales in Japan would be sourced 50% in Japan (country of sale) and 50% in the U.S. (country of manufacture). The President's proposals do not specify the relative weights that they would accord the jurisdictions of sale and manufacture. We have assumed that income would be sourced 25% & 75% to Japan & U.S., respectively.

INTERNATIONAL TRADE COUNCIL
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Text Submitted for Testimony
before the
Finance Committee
U.S. Senate
by
Peter T. Nelsen
President
International Trade Council
Washington, D.C.
Subject: The Impact of the Proposed Tax Reform on the International Competitiveness of U.S. Business

The International Trade Council testifies today on behalf of its member companies in 49 states that produces hundreds of finished goods and services that are exported world-wide. These companies are very concerned by the declining international competitiveness of U.S. businesses and the mounting U.S. trade deficit. Our stand is that certain provisions of the President's proposed tax reform, even with the stated tax reduction to 33% , will further damage U.S. international competitiveness. Specifically, the repeal of the Investment Tax Credit and changes in capital depreciation schedules will also put U.S. companies in an even more disadvantageous position relative to the export assistance received by their foreign competitors.

The International Trade Council also clarifies the causes of the United States' declining international competitiveness. Most importantly, U.S. government export assistance programs do not meet the need of U.S. companies for export assistance and, secondly, the programs that do exist are far from competitive with the more substantial assistance programs offered by our overseas competitors.

The International Trade Council suggests two al-

ternatives to the aforementioned tax reform provisions that we feel will help U.S. companies maintain, and even improve, their international competitiveness:

1) Deductions on export-related production loans, and
2) Corporate tax deductions for export marketing costs.

With most private banks hesitant to provide venture capital for export expansion, especially to small businesses, the government must take most of the responsibility for providing internationally competitive export assistance. Thus far they have failed to do so at a level required by U.S. companies so that they can remain competitive in the international market, and the President's proposed tax reform can only worsen this already inequitable situation.

The International Trade Council advocates incorporation of the two aforementioned alternatives and a comprehensive policy statement from the White House and Congress that makes a clear commitment to U.S. export expansion and to increased international competitiveness. Such a commitment would be a major step toward generating increased U.S. productivity so that the budget can be realistically balanced by additional export-related revenue, rather than by negative legislation and continued deficit financing.

Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify for you today. I am Peter Nelsen, President of the International Trade Council, which is a trade association of U.S. exporting businesses.

A major concern of the ITC is the continuous decline in the international competitiveness of U.S. business that this country has experienced in recent years; furthermore, the causes of this decline concern us. We are here today to propose alternatives to the negative effect that certain provisions of the Administration's proposed tax reform will have on the international competitiveness of U.S. businesses.

As it stands today, the Administration's tax reform proposal will cut corporate deductions to such an extent that the net result will be a corporate tax increase, not decrease. In addition, if they are implemented, the proposed repeal of the Investment Tax Credit and changes in depreciation schedules so that deductions for capital equipment depreciation are restricted will place U.S. exporters at a disadvantage to the foreign competitors who receive government-sponsored export assistance that the U.S. producer does not receive.

In our testimony today we intend to substantiate that U.S. exporters are indeed at a competitive disadvantage in the world market due to the relative lack of export assistance the U.S. government provides. Furthermore, the provisions of the proposed tax reform mentioned above can only make that situation worse.

The International Trade Council is solution-oriented and therefore we will propose some alternatives to the situation that we feel are both constructive and within the spirit of the President's and Congress' goals for the U.S. economy; namely, to encourage U.S. international competitiveness, rather than limit or impede it.

Our first proposal is for a direct deduction of all interest charged on export-related production loans made by exporting businesses for up to 6 months and a similar deduction on overseas buyers credit terms, also for up to 6 months. The total of these two items would therefore not exceed a 12 month deduction at the Prime Rate. These deductions are not contrary to the GATT rules and would help provide the kind of financial advantage that many U.S. companies currently lack, but many of their foreign competitors possess. At present, with these advantages, other countries are able to outdistance the U.S. in export volume, and therefore contribute to our alarmingly high trade deficit.

Second, we propose the adoption of a tax provision that would allow U.S. producers to deduct half the export marketing costs (not to exceed 5% or $250,000) associated with the first $5 million worth of exports they produce each year from their taxes, rather than from ordinary expenses or corporate revenue. This provision would not only help finance their export sales in new markets, it would also save small businesses the up-front expense of creating a Foreign Sales Corporation (FSC) for a limited amount of annual overseas business.

These two proposals would help offset the disadvantage U.S. businesses, especially small- to mid-sized ones, will suffer if the proposed restrictions on their international competitiveness are imposed by passage of the tax reform.

Numerous studies and publications indicate a general consensus regarding our concern for the decline of U.S. international competitiveness.

The House Export Task Force, a bi-partisan congressional caucus formed in 1978 to support legislative action designed to expand international trade, reported that " to survive and progress as a world leader, the U.S. must be more competitive in the world marketplace. We must recognize the new economic realities and deal effectively with them." Specifically, the Task Force identified "a wide array of impediments, many of which are imposed by our own government." They also recognized the fact the U.S. government export assistance is not nearly substantial enough, especially in comparison to that offered by other overseas governments, to support an appropriate level of exports. The Task Force had the vision to realize that our decline in exports and our growing trade deficit have a significant domestic impact in the U.S. economy in that, for example, "every additional billion in exports creates at least 25,000 new jobs."

Another factor in the declining international competitiveness of U.S. business was explored by the Subcommittee on International Economic Policy and Trade in August, 1984 when they noted that, despite the passage of the Export Trading Company Act in 1982, export trading companies have failed to become " a prominent force for the U.S. in international trade." One of the major culprits in this lack of support seems to be the Eximbank, who approved only 17 applications for ETC working capital guarantees (totalling 20.2 million dollars) between the passage of the ETC Act in 1982 and the Subcommittee's report in 1984. The Subcommittee noted that much more ETC

growth would be required in order to make any progress toward reducing the U.S. trade deficit, which was estimated by the U.S. Department of Commerce at $100 billion in 1983.

Although it has been argued that better marketing of the services Eximbank has to offer small businesses, which has been in effect since the fall of 1983, is enough to increase the number of ETCs that receive Exim-sponsored export assistance, others have noted that more substantial hurdles exist in the government that make it difficult for ETCs to operate effectively. Arthur Sultan, CEO of Citicorp International Trading Company, noted that restrictions on position-taking (i.e., the ETCs' taking title to a commodity before finding a buyer), on business venues (ETCs are not permitted to operate domestically), on exports of services, and, especially on countertrade, all represent "needless disincentives" imposed on ETCs by U.S. government regulations that restrict their ability to trade internationally.

Because Exim has consisently failed to meet its mandate, we need a clear policy statement of commitment to increasing export trade from the White House and from Congress. We suggest that such a policy can be put into practice by implementation of the proposed tax revisions that the International Trade Council has outlined in this testimony.

In 1984, the President's Commission on Industrial Competitiveness explored several of the major concerns regarding our declining international competitiveness and even made several recommendations as to how we can boost U.S. sales overseas. For example, the Commission recommended the expansion of Exim's offices so that they can do more business with small- and mid-sized companies that possess export potential. They also urged the repeal of certain laws that restrict U.S. export expansion and international competitiveness, such as the requirement for Presidential approval on loans to five East European countries, which necessarily restricts U.S. companies from competing with European manufacturers in that area. The Commission's recommendations represent one of the few examples of positive initiatives (the Export Administration Act of 1983 which contains a similar provision for Presidential restraint is another) that are welcomed and encouraged by the business community as viable ways to increase U.S. exports and, therefore, our international competitiveness.

The only problem with these positive initiatives is that, when

legislation is passed in connection with it, it quickly becomes ineffective because of restrictions that are placed on it or because it is negated by counter-legislation that puts even more effective restraints on U.S. international competitiveness. For example, sensitive industries such as steel and textiles have resorted more than once to Section 301 of the Trade Act of 1974 which gives the President authority to retaliate against the unfair, restrictive trade barriers of foreign governments. Instead of looking for ways to " retaliate ", we should be looking for more constructive methods to lower international trade barriers, including our own.

Although the United States is obliged to work within the GATT as it exists, it is also important to encourage innovation in our international trade policy. In 1984, Reagan administration initiated a substantial effort to create new ways to get around some of the restrictions that GATT has imposed on the U.S. international competitive advantage in such important categories as services, agriculture and high technology. Likewise, although we recognize the importance of encouraging Third World countries to lower their trade barriers, the International Trade Council also highly commends all efforts to decrease U.S. trade restrictions, thereby helping to curb domestic inflation, discouraging upward pressure on consumer prices and setting a " free-trade trend" for other countries to follow.

We hope to have made clear in this testimony that the U.S. is clearly at a disadvantage in many areas of our export trade and that our international competitiveness has been declining at an alarming rate in recent years.

In conclusion, we would like to emphasize that the negative impact of the proposed repeal of the Investment Tax Credit and changes in the accelerated cost recovery system will have on U.S. business, especially small companies, cannot be offset by even a substantial decrease in the top corporate tax rate, as is also proposed. These tax reform provisions can only impede the ability of U.S. companies to compete effectively in the international market, especially when the governments of our foreign competitors offer export assistance that compares much more favorably than that available from the U.S. government.

Besides the specific alternatives that we have suggested (i.e., interest deductions on export-related loans and tax deductions on

export marketing costs), a number of other sources have substantiated the importance of maintaining the Investment Tax Credit and the current accelerated cost recovery system for deductions on capital equipment. These two provisions are in danger of repeal by the President's tax reform proposal.

Just last week, in a hearing by the House Subcommittee on Tax, Access to Equity Capital and Business Opportunities, the National Association of Manufacturers testified that " reducing the accelerated cost recovery system, imposing a 'recapture tax' and doing away with the Investment Tax Credit (ITC) could have a negative effect on smaller businesses." NAM also emphasized the importance of not simplifying the tax system at the expense of productive capital investment and the ability of U.S. companies to compete internationally and provide jobs domestically.

Chairman of the Committee Thomas A. Luken (D-Ohio) said that " already reeling from the impact of unrelenting and unfair foreign competition, our manufacturers don't need to be pushed off a cliff by punitive tax proposals."

Another witness, Robert C. Laumann, President of Technical Equipment Sales Company, stated that only retention of the Investment Tax Credit can assure that the U.S. stays abreast of its international competition by encouraging technical innovation and incentive for investment. Without the Investment Tax Credit, U.S. jobs, manufacturing, and investment will be shifted abroad where labor and capital are cheaper.

We at the International Trade Council emphasize that alternatives to the provisions of the proposed tax reform mentioned in this testimony do exist (we have presented several of our own here) and should be considered as more positive ways to maintain, and even increase, U.S. international competitiveness.

Levi Strauss & Co. Levi's Plaza 1155 Battery Street San Francisco, California 94106 Phone 415 544-6000

July 11, 1985

Mr. George Yin
Tax Counsel to the Majority
Senate Finance Committee
219 Dicksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Yin:

Enclosed is a letter summarizing the domestic apparel industry's views that the President's Tax Proposals will significantly improve the industry's international competitiveness. The letter was prepared at the request of Mr. Charles R. Carlisle of the Office of the U.S. Trade Representative.

We appreciate your invitation to testify before the Senate Finance Committee on July 18 on the international competitiveness aspects of the proposed tax legislation. As discussed, however, we will be unable to testify due to schedule conflicts connected with our Board of Directors meeting. We hope, however, that the enclosed letter can be placed in the Senate Finance Committees' written record. Further, we would be pleased to provide you with any additional information or assistance on this matter and would be available to testify at later hearings.

Sincerely,

LEVI STRAUSS & CO.

Marty Slick
Sr. Mgr. Tax Planning
& Research
Corporate Tax Department

cc: Peter Phillipes

Enclosure

July 2, 1985

Mr. Charles R. Carlisle
Office of U.S. Trade Representative
Washington, D.C. 20506

Dear Mr. Carlisle:

As we discussed last week, the apparel industry enthusiastically supports the President's Corporate Tax Proposals. If enacted, they will significantly improve the domestic apparel industry's international competitiveness by bringing its effective tax rate closer to that of its major offshore competitors in Hong Kong, Taiwan and Korea and by reducing the cost of funds required to continue investing in plant modernization.

The testimony of Robert D. Haas, President and Chief Executive Officer of Levi Strauss & Co., before the Committee on Ways and Means of the U.S. House of Representatives on June 27, 1985, noted that the domestic apparel industry's effective tax rate is approximately 39%. Many companies, like our own, pay an even higher rate. We believe this to be the highest effective rate of any major U.S. manufacturing industry.

We estimate that our major competitors in Hong Kong, Taiwan, and Korea, benefit from effective tax rates of between 14% and 25%. This allows apparel producers in these countries to offer products in the U.S. at wholesale prices 6% to 8% below what a U.S. manufacturer must charge to earn the same after tax income, even if labor costs are assumed to be the same, which they are not (See Exhibit 1).

The President's Tax Proposals would reduce the domestic apparel industry's effective tax rate to approximately 30% by lowering the corporate tax rate to 33% and allowing a deduction of 10% of dividends paid. This would eliminate a large portion of the tax driven wholesale price advantage currently enjoyed by our major foreign competitors. (See Exhibit 2.)

It should be noted that the attached exhibits understate the price advantage enjoyed by foreign manufacturers since they only take into account effective income tax rates. In fact, foreign governments offer many other financial incentives. For example, export manufacturers in Taiwan and South Korea are entitled to foreign exchange loans at reduced interest rates which are repayable from export proceeds.

The current effective tax rate imposed upon the domestic apparel industry causes garment manufacturers to pay a higher price for their capital funds than companies in other U.S. industries, most of which enjoy a considerably lower (effective) rate. Internally generated funds available for investment are reduced and competition with low taxed industries for external funds is difficult. The proposed corporate tax changes will help to remedy the situation by lowering apparel's effective rate and eliminating the wide disparity between different industries. Enactment of the President's proposal is critical if the U.S. apparel industry is to remain competitive both in the retail marketplace and in terms of investment for plant modernization.

If we can provide you any additional information on this matter please call upon us.

Sincerely,

LEVI STRAUSS & CO.

Marty Glick
Senior Manager Tax Planning
& Research
Corporate Tax Department

MG/glh

Exhibit 1

Impact of Effective Tax Rates
On International Competitiveness
of Domestic Apparel Manufacturers

Assuming Domestic Effective Tax
Rate at 43%*

	Domestic Manufacturer	Taiwan Manufacturer	South Korea Manufacturer	Hong Kong Manufacturer
Percent Reduction in Wholesale Selling Price	N/A	6.2%	7.1%	8.6%
Selling Price	$ 12.00	$ 11.26	$ 11.15	$ 10.97
Cost of Sales	(7.00)	(7.00)	(7.00)	(7.00)
Gross Margin	5.00	4.26	4.15	3.97
Operating Expenses	(2.00)	(2.00)	(2.00)	(2.00)
Profit Before Tax	3.00	2.26	2.15	1.97
Federal Income Tax:				
U.S. at 43%	(1.30)			
Taiwan at 25%		(.56)		
South Korea at 21%			(.45)	
Hong Kong at 14%				(.27)
Earnings After Tax	1.70	1.70	1.70	1.70

*Although industry average is approximately 39%, many industry leaders estimate their effective rate to be closer to 43%. 43% used for this comparison.

Exhibit 2

Impact of Effective Tax Rates
On International Competitiveness
of Domestic Apparel Manufacturers

Assuming Domestic Effective Tax
Rate at 30%

	Domestic Manufacturer	Taiwan Manufacturer	South Korea Manufacturer	Hong Kong Manufacturer
Percent Reduction in Wholesale Selling Price	N/A	1.4%	2.4%	3.9%
Selling Price	$ 11.42	$ 11.26	$ 11.15	$ 10.97
Cost of Sales	(7.00)	(7.00)	(7.00)	(7.00)
Gross Margin	4.42	4.26	4.15	3.97
Operating Expense	(2.00)	(2.00)	(2.00)	(2.00)
Profit Before Tax	2.42	2.26	2.15	1.97
Federal Income Tax:				
U.S. at 30%	(.72)			
Taiwan at 25%		(.56)		
South Korea at 21%			(.45)	
Hong Kong at 14%				(.27)
Earnings After Tax	1.70	1.70	1.70	1.70

UNIVERSITY OF OREGON

July 8, 1985

Ms. Betty Scott-Brown
Finance Committee
Washington, D.C. 20510

Dear Ms. Scott-Brown:

As your hearing's rules provide on p. 3, I am attaching to this note five copies of a four page statement entitled "Why VAT is Not Regressive". I believe this general tax reform submission to the Finance Committee would be most appropriately assigned to the hearing scheduled for July 18, 1985.

Thank you for this opportunity.

Most sincerely,

R. W. Lindholm

Richard W. Lindholm Ph.D.
Emeritus Dean and Professor of Finance

RWL:hh

Enclosure

DEPARTMENT OF FINANCE • COLLEGE OF BUSINESS ADMINISTRATION • EUGENE, OR 97403-1208 • (503) 686-3353

An Equal Opportunity, Affirmative Action Institution

WHY VAT IS NOT REGRESSIVE

One of the common errors made by those who think of VAT as nothing more than a complex retail sales tax (RST) (see chapter "VAT in Action Around the World") is to judge VAT regressive as is true of the RST. A first point to be made in developing an understanding of the difference between the location of the economic burden of and RST and a VAT has to do with the portion of personal income that is saved.

Those with medium and relatively high incomes do most of the personal saving. This means a higher percentage of the income of these people is not used to directly make purchases. Rather, these income receivers are much more likely to save a portion of their income than are those with a lower realized personal income. Under the RST this saved income does not directly become a portion of the base to which the RST is applied. Income saved is income not taxed by the RST. The income saved becomes available for purchase of buildings and machines not included in the RST base which consists mostly of consumer goods, from bananas to dresses.

Use of Savings

We all realize that income saved is not just thrown away. Saved income is spent to finance private investments of all kinds and is also used to purchase government debt that provides funds used to finance transfer payments from social security to veteran pensions and also to finance

highway construction, education and the like. All of these uses for savings are a portion of the base of a good VAT. They are not excluded from the VAT base as they are from the RST base.

The portion of income saved under a VAT is spent and taxed just as truly as income spent directly under an RST. However, and this is the important point to make clear, the conventional uses of savings under RST are not included somewhere else as a portion of the RST base, but this is the case with VAT. Under both VAT and RST savings are not spent for consumption directly, but under VAT they are included in the taxable base when they are used to finance machines, buildings and the like. This, of course, is not true of RST.

Because under RST only purchases for final consumption by individuals is a part of the base and because high and middle income people save more of their income, the RST is regressive. Also, because VAT taxes all production at a constant percentage, and not just retail sales, it is a proportional tax, i.e., an equal percentage of all value-added becomes VAT revenues.

Avoidance of Double Taxation

A business in a VAT using nation that purchases a machine pays the price of the machine plus the VAT paid by the seller of the machine. When the products of the machine are sold a VAT equal to the rate of VAT applied to the purchase price of goods sold is collected. This VAT

collected on sales is reduced by the VAT paid on the machine plus any other VAT paid on raw materials and the like. This deduction, from the VAT due on sales, of the VAT paid on capital equipment purchased does not result in an exemption of machines and therefore of savings from VAT. What it does is to prevent production resulting in the sale of machines from being taxed twice.

If VAT paid on the machine was not deductible from VAT due on the products of the machine, the machine would bear a double VAT burden. There would be the final VAT burden on the machine when sold plus the VAT burden on the original energy, parts and raw materials used in producing the machine. So what we have when the VAT paid on the machine is deducted from VAT due on sale of finished products is not an elimination of VAT due and paid on savings but the prevention of double taxation of income saved and therefore largely spent for investment and not for consumption.

This discussion of the location of taxes in the economic process brings us to consideration of the flow of goods and services from the producer to the consumer. First emphasis needs to be placed on the point that prices as collected in the private and public sectors must be sufficient to cover all costs, including taxes!

If prices in the private sector rise to meet higher costs due to higher taxes, the price rise is not inflation, but rather the inclusion into prices of additional services

available free or below cost from government. The price of a consumer good must include the costs of intermediary goods from buildings to machines to raw materials and energy. The end use or purpose of all economic activity, private as well as public, is consumption. Investments are intermediary goods as are, of course, raw materials and energy. It is the utilization of these intermediary goods and services with labor that results in a new product or service available for consumption and to produce satisfaction.

Conclusion

This all works out to make VAT a proportional tax. A tax that also avoids the double taxation so much a part of the taxation of savings and profits through the personal and corporate income taxes and even in the actual administration of the RST and to some extent a purposeful part of RST legislation.

Richard W. Lindholm, Ph.D.
Professor and Dean Emeritus
of Business
College of Business Administration
Author of *A New Federal Tax System*

UNIVERSITY OF OREGON
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WHY A FEDERAL RETAIL SALES TAX
IS NOT THE APPROPRIATE TRANSACTION-BASED TAX

The discussions of the value-added tax (VAT) now appearing in both formal and informal discussion are often guilty of developing a number of nuances that should be switched back to the broad road of reality.

First, VAT did not originate in Europe. The generally recognized father of the U.S. income tax, T.S. Adams (of the University of Wisconsin) advocated VAT and wrote of it in 1911. Next came a German, then more Americans. The U.S. advisory group even tried to export the concept to Japan after World War II. Also, Michigan's value-added tax, now called the Single Business Tax, preceded the French law. It would, in fact, be appropriate to label the value-added tax base concept as an American child.

Second, the retail sales tax cannot carry the revenue burden that is considered to be appropriately tied to transactions. Sweden became aware of the problem and repealed their U.S. type retail sales tax and initiated a VAT. Sweden, not being a member state of the EEC, was not required to move in this direction as one might argue was true later for the United Kingdom and Ireland.

The proposal, often made, that the federal goverment could and should piggy back on 47 different definitions of taxable sales, is really preposterous. Every state revenue administration worth its salt would be busy reducing the base available for taxation. The states without a retail sales tax would dislike being forced to adopt an 'average tax' to facilitate collection of a federal retail sales tax.

A retail sales tax, because it is levied only at retail, does not provide much of a base for refund on exports or for a border tax on imports. The value-added tax's international trade characteristics are now giving some 18 value-added tax using nations an international trade advantage over the U.S. In order to make this sort of statement it must be assumed that taxes,

including the retail sales tax, are not included in prices. This, of course, cannot be done. In a fashion, every price is a payment for a joint purchase - the product from the private sector and taxes from the public sector.

The U.S., by adopting a substantial value-added tax, is contributing to the health of the free world's economy. Harmonizing its tax system with that of other industrial nations reduces tax-determined economic decisions. If transaction taxation in the U.S. is to be integrated, the way to go is for states to piggy back on the value-added tax base developed by the federal government. This could be a voluntary decision on the part of state and even local governments.

Richard W. Lindholm
Emeritus Dean of Business
University of Oregon
Eugene, OR 97403

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Committee on Finance
United States Senate
Public Hearing of July 18, 1985
Concerning
the Impact of the
President's Tax Reform Proposal
on the
International Competitiveness of U.S. Businesses

July 22, 1985

Statement of the
Machinery and Allied Products Institute
to the
Committee on Finance
United States Senate
Public Hearing of July 18, 1985
Concerning
the Impact of the
President's Tax Reform Proposal
on the
International Competitiveness of U.S. Businesses

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to submit its comments in connection with the Committee's hearings concerning the impact of the President's tax reform proposal on the international competitiveness of U.S. businesses. We ask that our statement be entered in the record.

MAPI and Its Interest

As the Committee may know, MAPI is the national organization of manufacturers of capital goods and allied products. The Institute and its affiliate, the Council for Technological Advancement, act as the national spokesman for the industries so represented and conduct original research in economics and management. Apart from traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high technology industries.

The Institute's membership consists of a wide range of companies, large and small, which produce highly engineered goods for worldwide sale. They both contribute to and are dependent on the

viability of the U.S. economy. Effective participation of U.S. based companies in both foreign and domestic markets is increasingly important to the health of the American economy. The complexity, scope, and technological advancement of the global marketplace have grown at a geometric pace in recent years. So too, the hurdles faced by U.S. business have increased. The budgetary deficit, the high U.S. dollar, the growing U.S. trade deficit, the ever-increasing competitiveness both here and abroad of foreign-based companies, and a host of other factors have presented and continue to present tremendous challenges.

The ability of U.S. industry to effectively meet these challenges will be much affected by U.S. policies concerning the domestic economy and international trade in the coming years. The Institute and its membership are deeply concerned about the impact of tax reform, as proposed by the Administration, on international trade and the competitive posture of American business.

Summary of Position

The Institute commends the Administration and Congress for their interest in reviewing the U.S. federal tax system. We also welcome the Committee's consideration of the impact of the President's tax reform plan, generally, and its proposals concerning foreign source income, specifically, on international trade. We find the Administration's tax reform package noticeably deficient in discussion of the proposals' international ramifications.

As we have previously commented to this Committee by letter of July 12, 1985, we believe that substantially reducing the deficit rather than accomplishing a full-scale overhaul of the tax system, is the first

priority confronting this country. However, we recognize the commitment of the President and of many members of Congress to "tax reform," and urge that all proposals be carefully weighed for their individual and collective economic impact. A necessary ingredient of a healthy U.S. economy, of course, is vibrant and effective participation in international trade. Thus, we strongly feel that this Committee should review the federal tax system in an international, as well as a domestic, perspective.

We are not convinced that the benefits of the proposed reductions in individual and corporate rates would outweigh the negative impact on the economy and on trade of certain of the tax reform initiatives offered by the Administration. Significantly, these include the proposals to (1) replace the barely 4-year-old Accelerated Cost Recovery System (ACRS) with a "Capital Cost Recovery System" (CCRS); (2) repeal the investment tax credit; (3) impose a "recapture tax" on previously allowed accelerated depreciation; and (4) redesign the foreign tax credit limitation and sourcing rules.

These proposals, individually or collectively, would increase the costs of capital formation and of doing business. They would further slow and perhaps altogether stop the very gradual recovery of many industries from the last recession. They would place U.S. industry at a further disadvantage vis-a-vis foreign competitors.

In that connection, we note with interest and approval the testimony before this Committee of two witnesses, Edmund T. Pratt, Jr., Chairman and Chief Executive Officer, Pfizer Inc., and Laurence J. Mauer, Ph.D., Associate Professor, St. John's University, who urged that

the proposals would adversely affect both the domestic economy and the international competitiveness of U.S. businesses. We agree with the assertion of both witnesses that the Administration's capital recovery proposals would result in reduced capital investment, decreased productivity, and increased export of plants and jobs. Furthermore, we support Mr. Pratt's observation that the research tax credit and the moratorium on allocation to foreign-source income of U.S.-based research and development expenditures are crucial to the technological progression of U.S. business.

Finally, we share the concern expressed by Mr. Pratt that our economy would be hard pressed to absorb in a single dose the full impact of the Administration's numerous and highly complex proposals. Thus, we restate our recommendation that each proposal and all of the proposals taken together be carefully studied not just for their operation as part of the tax law, but also for their cumulative economic ramifications. Moreover, we urge that, if broad ranging reforms are to be enacted, they be phased-in slowly and with full respect for transitional issues.

Specifics.--To summarize, we have the following recommendations to offer:

1. ACRS should be retained as is, in the absence of any compelling need to cast it aside.

2. The proposal to "recapture" accelerated depreciation, which is really a penalty tax on capital investment and is conceptually flawed, should be abandoned.

3. The investment tax credit, possibly improved, should be retained.

4. The research tax credit--which complements the investment credit and is a significant incentive to

innovative activity--should be improved and be made a permanent part of the tax code.

5. The proposed substitution of a per-country limitation for the overall limitation on the foreign tax credit and collateral modifications in the source-of-income and deduction rules, which amount to little other than highly targeted efforts to raise revenues, should be rejected.

6. The carryover and carryback periods for the foreign tax credit should be extended to 15 and 3 years, respectively.

7. For purposes of the foreign tax credit, overall domestic losses should be subject to the same recapture applicable to overall foreign losses.

8. The possessions tax credit should be retained intact.

9. A certain and uniform approach to the tax treatment of foreign exchange gains and losses should be adopted.

10. A moratorium on allocation to foreign-source income of U.S.-based research and development expenditures under Section 861 should be extended indefinitely.

The first four of these recommendations were discussed in our presentation of July 12, 1985 to the Committee in the context of "capital formation" and will not be repeated here. Our commentary to follow consists of general observations on international competitiveness aspects of the Administration's proposals, with specific attention to our remaining recommendations, numbers 5 through 10 above.

The Impact of the Administration's Proposals on Trade, Generally

The Administration's tax plan is termed "The President's Tax Proposals to Congress for Fairness, Growth and Simplicity." The

admirable objectives suggested by this title, however, stop at the door of business taxation.

While, on the positive side, the plan offers substantial rate reduction and extension of the incremental research and development credit, its corporate and international provisions are largely aimed at revenue raising rather than balanced tax reform. Rather than simplify the Tax Code in this area, they would increase its complexity. By increasing the costs of capital formation and of doing business, they would hinder rather than promote growth. In the name of equity, they would withdraw resources from the investments needed to prevent the return of full-blown recession and to ensure the effective participation of U.S. business in world and domestic markets.

Investment, Productivity, and Tax Reform

A MAPI study currently being readied for publication, Trends and Prospects for U.S. Manufacturing in World Markets, points out that since the mid-1970s the U.S. balance of payments has shown a sharp deterioration attributable in a major degree to a worsening merchandise trade balance. Since 1981, this situation has been exacerbated by the extraordinary strength of the U.S. dollar.

Particularly affected has been the "machinery" sector, which until recently made the largest positive contribution to the merchandise trade balance. During 1984, the U.S. machinery trade balance moved into a deficit position. In a range of product categories, including telecommunications equipment, textile, sewing and leather machinery, metalworking machinery, and electrical machinery and apparatus, imports

now significantly exceed exports. Even in those areas such as office machinery and equipment in which exports exceed imports, the ratio of imports to exports has shown a marked increase.

The MAPI study further reports that comparative analyses of fixed investment and productivity growth in the United States and in other major industrial countries show that high levels of investment are associated with greater productivity growth and vice-versa.

A major factor influencing savings and investment and, thus, productivity growth is a nation's tax structure. Where direct taxes are greater relative to indirect taxes, productivity growth rates tend to be lower. In addition, a tax structure which favors investment will favor productivity growth, which in turn will tend to improve a nation's competitiveness in domestic as well as international markets.

Foreign capital goods producers increasingly are penetrating U.S. markets and are gaining a growing share of world markets. In many product areas, this trend will continue until the international competitive position of U.S. industry improves substantially. Such improvement will depend on many factors, including most importantly reducing the federal budgetary deficit, which should lead to further reductions in interest rates and a more realistic valuation of the U.S. dollar. A decline in interest rates would also promote a pick-up in capital spending in the United States and create the potential for further noninflationary economic growth.

Any modification of the federal tax system should be carefully balanced to ensure that it does not work against achieving increased investment, renewed productivity growth, and stronger international

competitiveness for U.S. business. The Administration's capital formation and foreign tax proposals, we fear, would have a detrimental effect not offset by the proposed reduction in rates.

Specific Comments on the International Tax Proposals

Foreign Tax Credit

Under the Administration's plan, the amount of income tax paid to a foreign country which could be claimed as a foreign tax credit in any year would be limited to the U.S. tax on income from that country. The limitation with respect to each country would be a fraction of the total pre-credit U.S. tax equal to the ratio of taxable income from that country (determined under U.S. source-of-income rules) to worldwide taxable income.

The Administration, also, proposes a series of conforming modifications, including (1) expansion of the passive income category or "basket" (currently limited to passive interest income) to include dividends received from corporations in which the taxpayer has less than a 10 percent interest and gains from certain "passive income" assets; (2) permitting taxpayers to elect to deduct or to credit foreign taxes on a per-country basis; and (3) requiring the proration of losses (including U.S. losses) over all countries (including the U.S.) and all income baskets in proportion to their share of the loss year's worldwide taxable income, with resourcing of subsequent income in proportion to the previous loss allocation.

With respect to the deemed-paid credit, the Administration's plan would (1) require resourcing of dividends pro rata to the country

or countries from which the payor derived the accumulated profits (as defined) out of which the dividends are paid; (2) permit certain taxpayers to elect to use a specified formula to treat a portion of a subsidiary's residence country tax as if it had been paid to other countries in which the subsidiary derived income; and (3) deem dividend distributions and subpart F inclusions as made from the pool of all the distributing corporations' accumulated profits (or earning and profits in the case of subpart F inclusions) rather than as related to those from any particular year.

Generally, the proposals would be effective for taxable years beginning on or after January 1, 1986. A five-year carryforward of excess foreign tax credits (subject to the overall limitation) existing on the effective date would be permitted. For credits generated after the effective date, a ten-year carryforward would be allowed. Certain additional transition rules are specified in the proposal.

The purpose of the foreign tax credit.--The foreign tax credit has been an important feature of U.S. tax law since 1918. Its purpose is to limit double taxation of income derived in international transactions and subject to tax both here and abroad. The degree to which such double taxation is restricted is largely a function of the form of limitation on the amount of the credit. The type of limitation employed, in turn, tends to reflect U.S. policies concerning the degree to which foreign trade and investment should be encouraged./1 While

1/ See Owens, The Foreign Tax Credit, The Law School of Harvard University, Cambridge, 1961, pages 291-314.

U.S. policies are subject to change and have resulted in numerous modifications of the foreign tax credit and the limitation, the basic function of the credit (i.e., the reduction of international double taxation) has been maintained.

For certain companies within the MAPI membership, however, the Administration's proposals would have the effect of outright repeal of the credit. This would result from the combination of a per-country limitation and income source rules which in many cases would convert all income from the sale abroad of U.S. manufactured goods into U.S. source income. This result clearly is contrary to the credit's purpose and contrary, we think, to U.S. international trade goals.

A worldwide economy.--In justifying its per-country limitation proposal, the Administration asserts that "By restricting the ability of taxpayers to average high and low foreign taxes, the proposed changes will limit the foreign tax credit to its function of eliminating international double taxation of foreign income . . ." We disagree. Instead, the per-country limitation would exacerbate the very real problem of such double taxation in no small measure because it assumes that the world economy of today can be conveniently divided according to national boundaries. As has long been recognized, this simply is not the case.

Indeed, in its 1960 report on P.L. 86-780 which reinstituted the overall limitation after a six-year hiatus, the Ways and Means Committee observed:

> These two limitations represent basically different concepts of the relationship between domestic and foreign income. The overall limitation

> in effect treats the taxpayer's income as being divisible into two parts, domestic and foreign. Thus, under this limitation a foreign tax credit is allowed for any foreign income taxes so long as these taxes do not represent more than the U.S. tax rate applied to the taxpayer's total foreign income. The per country limitation, on the other hand, treats the taxpayer's income as being divisible into many parts, his domestic income and his income from each foreign country, and applies the limitation separately to each.
>
> In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation. [Emphasis supplied.]/1

If anything, these insights are more true today than they were 25 years ago. A product ultimately sold for use in country Z may have been manufactured partially in country V and partially in country W, assembled in country X, and marketed out of country Y, all under the overall management of a parent company located in the United States. Each of these countries has participated in the production and sale of the product. Each has a legitimate interest in taxing the proceeds of the transaction according to its own concepts of source of income and measure of taxation.

The United States asserts its jurisdiction to tax the entire proceeds, whether directly in the case of branch operations or when repatriated by dividend or by operation of subpart F in the case of a

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1/ House of Representatives Report No. 1358, 86th Congress, 2nd Session, March 8, 1960, page 866.

parent/subsidiary structure. Permitting the averaging of high and low tax rates applied by the various interested jurisdictions seems only appropriate and does tend to account for at least certain differences in rules concerning the definition of income, timing of its recognition, allowance of deduction, and sourcing of items of income and deduction. This, indeed, was the observation of a 1977 Ways and Means Committee Task Force on the Taxation of Foreign Source Income. In its report, the Task Force said:

> In many instances this averaging of foreign taxes would appear to be appropriate. Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation./1

In addition, the overall limitation reduces, we believe, incentives to artificially adjust the source of income. The 1977 Ways and Means Task Force also commented on this point and stated:

> In addition, even the per-country limitation permits some averaging of income since a taxpayer often has considerable discretion in which country income is to be sourced. For example, under existing source rules, dividend income is attributable to the country in which the foreign corporation paying the dividend to the U.S. shareholder is incorporated. Thus, a corporation could, for example, interpose a first-tier Bermudan

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1/ Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, March 8, 1977, page 35. It should be noted that on page 385 of "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity," May 1985, the Administration does indicate that it "will consider workable options for calculating the credit on a regional or integrated operation basis if that can be done in a manner consistent with the underlying rationale of the per-country limitation."

> corporation as the parent of second-tier subsidiary corporations operating in Germany and Panama. The taxes paid by the German and Panamanian corporations would be carried along (under the deemed-paid tax credit) with any dividend paid to the Bermudan company and then, when that company in turn pays a dividend to the U.S. shareholder, the taxes paid to both countries are combined and treated as if the Bermudan company had paid them to Bermuda./1

In our view, the overall limitation is the only realistic, practical, and indeed viable mechanism of accounting for the range of tax systems under which U.S. taxpayers do business and pay taxes while maintaining residual U.S. tax.

Bargaining chip.--In its description of reasons for changing the foreign tax credit, the Administration asserts, as follows:

> A second problem is that the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment. Under an overall limitation system, a company with operations in a low tax country is able to invest in a high tax country without bearing the full burden of the high foreign tax. The overall limitation inappropriately requires the U.S. Treasury to bear the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income. A neutral U.S. tax system would require U.S. corporations to bear the full burden of high foreign taxes rather than allowing these costs to be passed on to the U.S. Treasury and other taxpayers through the foreign tax credit mechanism. As a result of adopting a per country limitation, high tax countries may find it appropriate to reevaluate their rules for taxing U.S. capital. Such countries would have a stronger incentive to adopt lower taxes either unilaterally or through the treaty process. [Emphasis supplied.]/2

1/ Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, March 8, 1977, page 35.

2/ "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity," May 1985, pages 387-8.

This type of "bargaining chip" argument appears to be a recurring theme in the formulation of U.S. international tax policy. The Institute believes that good tax policy cannot be the product of unilateral initiatives which burden U.S. taxpayers solely for the purposes of attempting to mold other sovereign countries' approaches to taxing multinational business.

The Treasury attitude in question also seems to reflect a cynical view of other countries' perfectly legitimate interests in creating favorable investment climates and a certain paranoia regarding the reasons underlying the formulation by other countries of investment incentive programs. Moreover, it ignores the fact that our foreign competitors often benefit from programs and tax systems which offer far more incentive to capital and to international trade than does the U.S. system. Clearly, improving rather than further inhibiting the ability of U.S. companies to participate in world markets and compete with foreign-based companies would seem more important than attempting to force one or more nations to change their laws or to negotiate treaties.

Let us add that there is no truth to the assertion that a U.S.-based company whose foreign direct investment is rendered uneconomic by U.S. tax law will make its investments stateside instead. If a domestic investment already is inadvisable for tax or other reasons, it does not become feasible simply because Congress eliminates a foreign alternative. Similarly, it should be remembered that foreign

investment by U.S. firms results in the creation of jobs and the enhancement of industry at home.

Investment incentives.--The Administration appears to be of the opinion that U.S.-based multinational companies design their worldwide investment programs solely with reference to U.S. tax laws. This simply is not the case.

Taxes, those of the United States and those of other jurisdictions, are a cost of doing business and, as such, reasonably are a factor in any investment decision ranging from buying a warehouse to locating a manufacturing plant. However, they are but one factor among a host of considerations which enter into multinational investment decision making. A sample checklist might include, among many other items: (1) access to foreign markets; (2) exchange controls and restrictions on remission of dividends and intercompany amounts; (3) labor availability and costs; (4) other manufacturing and distribution costs; (5) existing industrial base; (6) legal, ownership, management and capital requirements; (7) non-tax incentives (e.g., grants, bonds, etc.); (8) financing; (9) infrastructure; (10) customs requirements; and (11) political environment. The overall picture, rather than any single factor, is determinative of how and where a company will locate a plant or operation.

As we have already mentioned, most of our trading partners do offer a range of tax and non-tax incentives available to U.S. and to foreign businesses. This is a legitimate exercise. It also presents a challenge for the United States to meet.

Administration and compliance.--The Administration concedes that the per-country limitation would involve "imposition of significant new burdens on both taxpayers and the Internal Revenue Service." We submit that this is a gross understatement. The tracing of income deductions and foreign tax credits that would be involved would add tremendously to the complexity of the law and to the uncertainties associated with compliance and administration.

Under the proposal, rules would require corporations at each level of the corporate structure to maintain separate "basket" accounts in each country from which they derive income. Such income would have to be segregated into separate categories (e.g., catchall and separate limitation baskets); taxes paid would have to be identified with each category; and expenses would have to be allocated and apportioned. Where a foreign subsidiary is taxed by its residence country on a worldwide basis, resourcing of income and taxes might be appropriate. In the subpart F context, the tracing would become even more involved to satisfy the proposals relating to the "pooling" of accumulated profits (or earnings and profits).

The administrative burden of tracking separate baskets of income and associated expenses and creditable taxes through every country and every tier of the corporate structure would be intolerable, particularly when one considers the large number of countries in which many U.S. taxpayers do business. We doubt that taxpayers could comply with the proposals, and we doubt that the IRS could effectively audit their compliance efforts. In addition, the costs associated with both compliance and administration would be several times current costs.

The international tax provisions of present law already are among the most complicated of the federal tax system. However, the overall limitation, encumbered as it is with allocations required under Section 861, sourcing and resourcing rules (particularly those added by the Tax Reform Act of 1984), and the Section 482 pricing requirements, together with the 1976 restrictions affecting foreign losses, represents an effort to promote equity, administerability, and protection of U.S. residual taxation. Indeed, this issue was specifically addressed by the 1977 Ways and Means Committee Task Force which stated--correctly we think--as follows:

> An equally important consideration in comparing the overall limitation by itself with a combination of the per-country and overall limitations is the relative burden which each approach places on taxpayers and on the IRS. The per-country limitation requires that a separate computation be made for each country in which a taxpayer operates. Each of these computations requires the taxpayer to calculate the gross income and deductions to be allocated to each country. Since, as discussed above, many large corporations operate on an integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world. These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group. [Emphasis supplied.] /1

1/ Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, March 8, 1977, pages 35-36.

We submit that the basic thrust of the per-country limitation proposal, i.e., the reduction of tax avoidance opportunities (and thus enhancement of revenues), could be better achieved by far less draconian measures. For example, the recommendations offered in the General Accounting Office's September 30, 1981 Report, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," are one prolific source of ideas for addressing compliance concerns. Possibilities such as these might better be explored before any further tinkering with the foreign tax credit limitations is attempted by Congress.

International economic objectives.--One feature of the Administration's international tax proposals which we find particularly surprising is the failure to discuss, or even mention, U.S. international economic policy or how the proposals would affect the competitiveness of U.S. business abroad. We submit that the per-country limitation would damage the ability of U.S. companies to compete in world markets because it would have the effect of increasing the cost of doing business abroad. To the extent a company operates in a country imposing a higher rate of tax than does the United States, it would be taxed at that higher rate. To the extent a company does business in a jurisdiction which imposes a lower rate of tax, it would be taxed at the higher, U.S. rate. Thus, U.S. taxpayers would suffer an increase in their tax cost of doing business abroad, and this at a time when maintaining U.S. competitiveness abroad already is disadvantaged by a number of factors including the high dollar, a growing trade deficit, and a balance of payments which is anything but balanced.

A further, and we think unintended, result of the Administration's per-country limitation proposal would be to skew investment decisions further in the direction of low tax countries and to encourage reinvestment in such countries whereas neutrality in such decisions would be preferable. To the extent companies are able to take taxes into consideration, economic decisions would be affected in just the fashion the Administration asserts it proposes to avoid. At a minimum, this would have a detrimental impact on the U.S. balance of payments. Further, it would increase any distortions that already exist in international investment decisions, which, as already mentioned, the Administration says it would prefer to reduce.

Export subsidies.--In its "analysis" section concerning its proposal modifications of the sourcing rules for income and deductions, the Administration states:

> It can be anticipated that under these proposals somewhat greater amounts of income of U.S. taxpayers derived from sales of products to destinations located outside the United States would be treated in the future as domestic source income. As a result some U.S. export activities would lose collateral foreign tax credit benefits if the exporting companies have excess foreign tax credits from their purely foreign activities. However, the United States should retain the primary taxing right over export income when the activities giving rise to the income are carried out in the United States and should not be granting foreign tax credits with respect to broad classes of income not generally taxed abroad. To the extent export subsidies are included in the tax law they should be overt and evenly applied./1

1/ "The President's Proposals for Fairness, Growth and Simplicity," May 1985, page 405.

We reject the assumption implicit herein that the foreign tax credit with an overall limitation is an export subsidy. The credit in its current configuration is a necessary mechanism designed to limit the international double taxation which inevitably flows from the U.S. assertion of worldwide taxing jurisdiction.

Sourcing Rules for Income and Deductions

The Administration proposes, effective generally for taxable years beginning on or after January 1, 1986, to modify several rules concerning the source of income and deductions. To summarize: income from the purchase and resale of inventory-type property would be sourced to the taxpayer's country of residence (with an exception relating to a fixed place of business located outside the residence country and participating materially in the sale); income from all sales to a taxpayer's foreign subsidiaries and affiliates would be sourced at the seller's residence; a fixed percentage of income from the manufacture and sale of inventory-type property would be sourced to the place of manufacture while the remainder would be sourced in accordance with the above-described rules for purchases and resales of inventory-type property.

The Administration, also, proposes to repeal the 80-20 corporation exceptions to the general source rules for dividend and interest income and to require allocation of interest expense incurred by a corporation joining in filing a U.S. consolidated return on a consolidated group basis. This change would apply only to interest paid on debt obligations incurred after January 1, 1986.

Uncertainty and complexity.--From the standpoint of most U.S. manufacturing companies, the most significant of the proposed changes is that which would modify the source rule for sales income. We submit that the proposal does not offer a definition sufficiently preferable to the long-standing "title passage rule" of current law to offset the uncertainties and complexity which inevitably would attend the development of rules concerning, and experience in applying, such a new standard. We feel that sourcing income from the purchase and resale of inventory-type goods to the taxpayer's residence country (subject to the "fixed place of business" exception) is no less arbitrary than the "title passage" rule, particularly in light of the anti-abuse provisions which have been developed over the years. Certainly, the sourcing of sales to foreign subsidiaries or affiliates is more arbitrary. Furthermore, the present-law approach encourages exports and places U.S. companies on a more equal footing with their foreign counterparts.

Without making the source rule less arbitrary, the Administration proposes to add to its complexity by adopting standards for using the exception which are unfamiliar in this context. Defining a "fixed place of business" and determining whether it "participates materially" would be difficult and would leave the characterization of too many transactions open to later resourcing or examination. In effect, the proposal would substitute for a clear and workable rule, a transaction-by-transaction, facts-and-circumstances determination susceptible to an unacceptable degree of uncertainty.

Allocation of interest expense.--The Administration's proposal to allocate the interest expense deduction on a consolidated group basis

is conceptually inconsistent with the philosophy underlying the proposed per-country limitation. On the one hand, the Administration recognizes the fungibility of money and interdependence inherent in the corporate structure. On the other, it seeks rigid adherence to a tracing principle. We submit that this inconsistency cannot be justified.

We also are concerned that the proposal would create substantial new complexities associated with determining correct allocations. Combined with the proposed per-country limitation, this would be particularly onerous.

The purpose?--Taken together with the per-country limitation proposal, the Administration's sale-income and interest-expense source rule recommendations appear to represent little more than "revenue grabbing." Certainly, they do not reflect simplification, equity, or growth.

Certain Other Matters

Extended carryover period.--We do support the Administration's proposed extension of the carryover period for excess foreign tax credits. We would suggest, however, that the period for both carryovers and carrybacks be conformed to the 3-year carryback and the 15-year carryforward applicable to the Section 38 General Business Credit.

Loss recapture.--We also support the Administration's proposal to provide for the recapture of domestic losses in a manner consistent with the treatment now accorded foreign losses under Section 904(f). The lack of symmetry in this area has been and continues to be a significant inequity and has resulted in international double taxation.

Possessions credit.--We oppose the Administration's proposal to replace the current possessions tax credit with a wage credit. We feel that the present law credit, limited as it is, is important to the international competitive posture of certain American industries; provides significant support to the economies of affected jurisdictions (notably Puerto Rico); and is a far more realistic incentive program than a wage credit would be.

Foreign exchange gains and losses.--The treatment of foreign exchange gains and losses under present law is uncertain and complicated. While we have not fully analyzed the underlying theory of the Administration's proposal (i.e., relating exchange rate fluctuations to differences in national interest rates), we do believe tax administration would be improved by adoption of a reasonably clear approach along these lines.

Moratorium on allocation of research and development expenditures.--The Administration has not proposed any extension of the moratorium on allocation to foreign-source income under Section 861 of U.S.-based research and experimental expenditures, enacted as part of the Economic Recovery Tax Act and scheduled to expire for tax years beginning after August 1 of this year. We believe that the moratorium should be extended indefinitely. The moratorium, together with the incremental credit for research and experimental expenditures, promotes investment in the development and implementation of new technology. If U.S. business is to be competitive at home and abroad, such investment is necessary.

Concluding Comment

What is perhaps most unfortunate about the international tax proposals offered by the Administration is that, though part of a "reform" package, they do not purport in any way to reform or even to consider overall reform of the basic mechanisms employed in U.S. taxation of international transactions. Rather, they are highly targeted proposals primarily aimed at raising revenues.

Generally, in our opinion, they are conceptually flawed and totally impractical from the standpoints of taxpayer compliance and IRS administration. Moreover, taken together with the Administration's "capital formation" proposals, the foreign-source income initiatives would unnecessarily encumber American business as it continues to strive towards overcoming the effects of the last recession and becoming as effective a competitor in world markets as it should be. Ultimately, these proposals would be damaging to the American economy.

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We hope that these comments will prove useful to the Committee as it continues its deliberations on comprehensive tax reform.

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